S. Hrg. 101-1041

TO AUTHORIZE THE FEDERAL DEPOSIT INSURANCE CORPORATION TO INCREASE DEPOSIT INSURANCE PREMIUMS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

S. 3045

TO AUTHORIZE THE FEDERAL DEPOSIT INSURANCE CORPORATION TO INCREASE DEPOSIT INSURANCE PREMIUMS AS NECESSARY TO PROTECT THE BANK INSURANCE FUND

S. 3093

TO AUTHORIZE THE FEDERAL DEPOSIT INSURANCE CORPORATION TO INCREASE DEPOSIT INSURANCE PREMIUMS AND TO BORROW WORKING CAPITAL FUNDS, AND FOR OTHER PURPOSES

SEPTEMBER 26, 1990

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TO AUTHORIZE THE FEDERAL DEPOSIT INSURANCE CORPORATION TO INCREASE DEPOSIT INSURANCE PREMIUMS

WEDNESDAY, SEPTEMBER 26, 1990

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10:06 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Wirth, Garn, Shelby, Dixon, D'Amato, Bond, Graham, and Heinz.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The **Chairman**. The committee will come to order.

Let me welcome all those in attendance this morning. We are pleased to have our witnesses, and particularly Mr. Glauber who will start off here.

Two weeks ago on September 11 and 12 this committee held hearings on the condition of the FDIC's Bank Insurance Fund. At that time, the heads of the General Accounting Office and the Congressional Budget Office testified to us that the fund's reserves are presently at an historic low of about 70 cents per $100 of insured deposits, and that many banks are in danger of failing at some point up the road in the next 2 or 3 years; and that this was creating stress that could cause the fund to actually run out of money.

The GAO and the CBO pointed out that the current law would permit bank insurance premiums to go up but limit them to 19.5 cents per $100 of deposits next year, even if the FDIC concluded that higher premiums were urgently needed.

To deal with that problem, I and several of my colleagues immediately proposed S. 3045 which lifts the caps on premiums and also lets the FDIC make mid-year adjustments to the premium rate. Obviously the goal of that legislation is to give the FDIC the flexibility that it needs to protect the fund should it find itself in very difficult circumstances.

Since then, the House of Representatives and the administration have put forward similar bills, and Senator Garn and I have introduced the administration's bill by request as S. 3093.

Now the administration's bill proposes three additional changes in the law.

First, the FDIC could raise the thrift premiums as well as bank premiums.

Second, the FDIC could allow the fund's reserves to rise above the current limit of $1.50 in reserves per $100 of insured deposits. The FDIC would no longer be required to pay rebates whenever reserves exceeded that level.

And finally, the FDIC could raise working capital through the Federal Financing Bank instead of having to rely on more costly forms of borrowing.

I want to indicate today that, as has been our practice since we started out in this chairmanship, we want to work with the administration and with Members on both sides of the aisle to pass legislation along the general lines of S. 3045, S. 3093, and the House bill.

[Copies of proposed bills follow:]

II

101st CONGRESS
2d Session

S. 3045

To authorize the Federal Deposit Insurance Corporation to increase deposit insurance premiums as necessary to protect the Bank Insurance Fund.

IN THE SENATE OF THE UNITED STATES

September 13 (legislative day, September 10), 1990

Mr. Riegle (for himself, Mr. Shelby, Mr. Kerry, Mr. Graham, Mr. D'Amato, Mr. Dodd, Mr. Cranston, Mr. Akaka, Mr. Wirth, Mr. Metzenbaum, and Mr. Simon) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To authorize the Federal Deposit Insurance Corporation to increase deposit insurance premiums as necessary to protect the Bank Insurance Fund.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. FDIC AUTHORIZED TO INCREASE BANKS' DEPOSIT INSURANCE ASSESSMENTS AS NECESSARY TO PROTECT THE BANK INSURANCE FUND.

(a) In General.—Section 7(b)(1)(C) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)(C)) is amended to read as follows:

"(C) ASSESSMENT RATE FOR BANK INSURANCE FUND MEMBERS.—

"(i) IN GENERAL.—The annual assessment rate for Bank Insurance Fund members shall be such rate as the Board of Directors, in its sole discretion, determines to be appropriate—

"(I) to maintain the reserve ratio at a level equal to the designated reserve ratio; or

"(II) if the reserve ratio is less than the designated reserve ratio, to restore the reserve ratio to the designated reserve ratio within a reasonable period of time.

"(ii) FACTORS TO BE CONSIDERED.—In making any determination under clause (i), the Board of Directors shall consider the Bank Insurance Fund's expected operating expenses, case resolution expenditures, and investment income, and the effect of the assessment rate on insured banks' earnings and capital.

"(iii) MINIMUM ASSESSMENT.—The assessment shall be not less than $1,000 for each member in each year.".

(b) AUTHORITY FOR FDIC TO MAKE MID-YEAR ADJUSTMENT IN ASSESSMENT RATES.—Section 7(b)(1)(A) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)(A)) is amended to read as follows:

"(A) ANNUAL ASSESSMENT RATES PRESCRIBED.—

"(i) The Corporation shall, from time to time, set assessment rates for insured depository institutions.

"(ii) The Corporation shall fix the annual assessment rate of Bank Insurance Fund members independently from the annual assessment rate for Savings Association Insurance Fund members.

"(iii) The Corporation shall announce any change in the annual assessment rates—

"(I) for the semiannual period beginning on January 1 and ending on June 30, not later than the preceding November 1; and

"(II) for the semiannual period beginning on July 1 and ending on December 31, not later than the preceding May 1.

II

101st CONGRESS
2d Session

S. 3093

To authorize the Federal Deposit Insurance Corporation to increase deposit insurance premiums and to borrow working capital funds, and for other purposes.

IN THE SENATE OF THE UNITED STATES

September 24 (legislative day, September 10), 1990

Mr. Riegle (for himself and Mr. Garn) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To authorize the Federal Deposit Insurance Corporation to increase deposit insurance premiums and to borrow working capital funds, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Deposit Insurance Funds Flexibility Act of 1990".

SEC. 2. FDIC AUTHORIZED TO ADJUST ASSESSMENT RATES AT SUCH TIMES AS APPROPRIATE.

Section 7(b)(1)(A) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)(A)) is amended—

(1) in the heading, by striking the word "Annual";

(2) in clause (i), by striking the word "annually" and inserting in lieu thereof "at such times as the Corporation, in its sole discretion determines to be appropriate";

(3) in clause (ii), by deleting the word "annual" each time it appears; and

(4) by amending clause (iii) to read as follows:

"(iii) The Corporation shall announce any change in the assessment rate for the semiannual period at least 30 days prior to the effective date of such assessment rate.".

SEC. 3. FDIC AUTHORIZED TO SET DESIGNATED RESERVE RATIO.

Section 7(b)(1)(B) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)(B)) is amended—

(1) by deleting ", not exceeding 1.50 percent," each time it appears therein;

(2) in clause (iii)—

(A) by inserting "and" at the end of subclause (I);

(B) by deleting subclauses (II) and (III); and

(C) by redesignating subclause (IV) as subclause (II); and

(3) in clause (iv)—

(A) by inserting "and" at the end of subclause (I);

(B) by deleting subclauses (II) and (III); and

(C) by redesignating subclause (IV) as subclause (II).

SEC. 4. FDIC AUTHORIZED TO INCREASE ASSESSMENT RATES AS APPROPRIATE.

(a) BANK INSURANCE FUND ASSESSMENT RATE.—Section 7(b)(1)(C) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)(C)) is amended to read as follows:

"(C) ASSESSMENT RATE FOR BANK INSURANCE FUND MEMBERS.—The assessment rate for Bank Insurance Fund members shall be such rate determined by the Board of Directors to be appropriate to maintain the reserve ratio at the designated reserve ratio or, if the reserve ratio is less than the designated reserve ratio, to restore the reserve ratio to the designated reserve ratio within a reasonable period of time, after taking into consideration and expected operating expenses, case resolution expenditures, and expected income of the Bank Insurance Fund, the impact on insured bank earnings and capitalization, and such other factors as the Board of Directors may deem appropriate, except that such rate shall not be less than the greater of—

"(i) 0.150 percent; or

"(ii) $1,000 for each member in each year.".

(b) SAVINGS ASSOCIATION INSURANCE FUND ASSESSMENT RATE.—Section 7(b)(1)(D) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)(D)) is amended to read as follows:

"(D) ASSESSMENT RATE FOR SAVINGS ASSOCIATION INSURANCE FUND MEMBERS.—The assessment rate for Savings Association Insurance Fund members shall be the rate determined by the Board of Directors to be appropriate to maintain the reserve ratio at the designated reserve ratio or, if the reserve ratio is less than the designated reserve ratio, to restore the reserve ratio to the designated reserve ratio within reasonable period of time, after taking into consideration the expected operating expenses, case resolution expenditures, and expected income (not including anticipated Treasury payments) of the Savings Association Insurance Fund, the effect on insured savings association earning and capitalization, and such other factors as the Board of Directors may deem appropriate, except that such rate shall not be less than the greater of $1,000 for each member in each year or—

"(i) 0.208 percent through December 31, 1990;

"(ii) 0.230 percent from January 1, 1991, through December 31, 1993;

"(iii) 0.180 percent from January 1, 1994, through December 31, 1997; and

"(iv) 0.150 percent after December 31, 1997.".

SEC. 5. ASSESSMENT PROCEDURES MODIFIED TO PERMIT SEMIANNUAL ASSESSMENTS.

Section 7(b)(2)(A) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(2)(A)) is amended—

(1) by striking the word "annual" each time it appears;

(2) in clause (i)(I), by inserting "during such semiannual period" after "member"; and

(3) in clause (ii)(I), by inserting "during such semiannual period" after "member".

SEC. 6. ASSESSMENT CREDITS AUTHORIZED WHEN RESERVE RATIO EXPECTED TO EXCEED DESIGNATED RESERVE RATIO.

(a) In General.—Section 7(d)(1)(A) of the Federal Deposit Insurance Act (12 U.S.C. 1817(d)(1)(A)) is amended—

(1) by striking "By September 30 of each calendar year" and inserting instead "No later than 30 days before the first day of each semiannual period"; and

(2) by striking "the succeeding calendar year" and inserting instead "such semiannual period".

(b) BANK INSURANCE FUND CREDIT.—Section 7(d)(2)(B) of the Federal Deposit Insurance Act (12 U.S.C. 1817(d)(2)(B)) is amended by striking "shall" and inserting instead "may".

(c) SAVINGS ASSOCIATION INSURANCE FUND CREDIT.—Section 7(d)(3)(B) of the Federal Deposit Insurance Act (12 U.S.C. 1817(d)(3)(B)) is amended by striking "shall" and inserting instead "may".

SEC. 7. FDIC AUTHORITY TO BORROW FROM FEDERAL FINANCING BANK.

Section 14 of the Federal Deposit Insurance Act (12 U.S.C. 1824 is amended—

(1) in the heading, by inserting "; sale of obligations to Federal Financing Bank" after "Savings Association Insurance Fund";

(2) by designating the text of such section as subsection "(a)"; and

(3) by adding after subsection (a) (as designated by this section) the following new subsection:

"(b) The Corporation is authorized to issue and sell obligations of the Corporation to the Federal Financing Bank established by the Federal Financing Bank Act, and the Federal Financing Bank is authorized to purchase and sell such obligations of the Corporation on terms and conditions determined by the Federal Financing Bank.".

The CHAIRMAN. This is "must do" legislation, and we have got a very short time window left open to us here in the remainder of this session of Congress. We want to get it done and on the President's desk within that time period.

This measure will help to protect the deposit insurance's fund in the short run. But it is not by any means a cure-all to our more fundamental and underlying problems. We also need more fundamental reforms to reduce the risk of the deposit insurance fund to the American taxpayer.

That is why I just yesterday have introduced, together with Senators Dodd, Shelby, D'Amato, and Wirth, the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1990 which has been numbered S. 3103. It is a very carefully drafted and conceived bill which is designed to prevent these problems from recurring in the future, and to put the deposit insurance system on a sound foundation.

That legislation cannot be enacted in the short amount of time that we have left, but it addresses directly the broader and the more basic underlying issues that will remain to be treated after today's effort to take the ceiling off the deposit insurance premiums.

So we will be hearing first from Treasury Under Secretary Robert Glauber, and then we will be hearing from John Bovenzi of the FDIC, and Don Chapin of the GAO.

So with that, let me yield to Senator Garn.

[The complete prepared statement of Chairman Riegle follows:]

PREPARED STATEMENT OF CHAIRMAN RIEGLE

Two weeks ago, on September 11 and 12, this committee held hearings on the condition of the FDIC's Bank Insurance Fund. The heads of the General Accounting Office and the Congressional Budget Office testified that the fund's reserves are at a historic low of just 70 cents per $100 of insured deposits, that many banks are in danger of failing during the next several years, and that the Fund could run out of money.

The GAO and CBO pointed out that current law would limit banks' insurance premiums to 19.5 cents per $100 of deposits next year—even if the FDIC concluded that higher premiums were urgently needed. To deal with that problem, I and several of my colleagues immediately proposed S. 3045, which lifts the caps on premiums and also lets the FDIC make mid-year adjustments in the premium rate. The goal is to give the FDIC the flexibility it needs to protect the fund.

Since then, the House of Representatives and the administration have put forward similar bills, and Senator Garn and I have introduced the administration's bill—by request—as S. 3093.

The administration's bill proposes three additional changes in the law. First, the FDIC could raise thrift premiums as well as bank premiums. Second, the FDIC could allow the funds' reserves to rise above the current limit of $1.50 in reserves per $100 of insured deposits. The FDIC would no longer be required to pay rebates whenever reserves exceeded that level. Finally, the FDIC could raise working capital through the Federal Financing Bank, instead of having to rely on more costly forms of borrowing.

I plan to work with the administration and with Members on both sides of the aisle to pass legislation along the general lines of S. 3045, S. 3093, and the House bill. This is must-do legislation.

It will help protect the deposit insurance funds in the short run. But we also need more fundamental reforms to reduce the risk to the deposit insurance funds and the American taxpayer. That is why I—together with Senators Dodd, Shelby, D'Amato, and Wirth—have introduced the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1990—S. 3103—which is designed to prevent these problems from recurring and put the system on a sound foundation.

We look forward to hearing this morning from Treasury Under Secretary Robert Glauber. He'll be followed by John Bovenzi [Bo-VENN-zee] of the FDIC and Don Chapin [CHAY-pin] of the GAO.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

As you mentioned 2 weeks ago, the committee heard testimony from the Comptroller General of the United States raising very serious questions about the health of the FDIC's Bank Insurance Fund.

Mr. Bowser warned that the fund was at its lowest level in history in terms of reserves to insure deposits; that it was expected to continue to suffer additional losses in the coming year.

The Comptroller General strongly recommended that we enact legislation this year to increase the flexibility of the FDIC to raise deposit insurance premiums as conditions may warrant.

I commend you, Mr. Chairman, for acting so quickly in responding to that request in holding this hearing today to consider the proposals to carry out the Comptroller General's recommendation.

I would also commend you for introducing a much broader deposit insurance reform, because that certainly is necessary—and I want to emphasize what you said: This is a short-term, stop-gap measure we are looking at, and we certainly, at the beginning of next year need to look not only at deposit insurance reform in a broad way, but also at the entire structure of our financial system as we did at the hearings that this committee has held all year long.

It is long past due for us to look at those structural changes. I would hope the Treasury Department will soon have their report on deposit insurance. I think the importance of introducing a bill, even though it cannot become law before the end of this session, is that it is there for discussion and for all of the information that we can gain during this period of time.

I think it will be helpful, whatever the final outcome of the bill is, or what form it takes, that we have Treasury's information. By introducing it now, it will form a discussion piece that will let us move much more rapidly at the beginning of next year.

The health of our deposit insurance fund and the impact of deposit insurance premiums on those funds and on the continued viability of our financial institutions are certainly of vital importance. It is critical that Congress act expeditiously to pass the necessary changes in the deposit insurance assessment rules this year.

However, it is also critical for Congress to fully consider the implications of its actions. It is possible that increasing deposit insurance too quickly and too much may prove counterproductive.

First, it may cause some institutions to fail that could otherwise have survived. Further, too drastic an increase may also have a negative impact on the ability of the FDIC and RTC to attract capital.

This is certainly something the industry needs at this time. This would also increase the cost to taxpayers of resolving our bank and thrift problem cases. That is why again I want to commend you, Mr. Chairman, for scheduling this hearing today so that we can gain some insight from the experts as to what would be an appropriate and balanced course of action to take.

Following this hearing, we should be able to move quickly to consider and, if necessary, refine the legislative proposals that have already been introduced.

At that point, we will be in a position to take the necessary action this year before we adjourn.

Let me emphasize this final point: Delay until next year is not acceptable. Further consideration and possible refinement of legislative proposals can be accomplished quickly and should not, and must not, prevent Congress from acting before we adjourn this year.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn, for your comments and your kind personal comments.

I want to say to you, as I have said many times before, that I want the committee to work closely together. I want this work to be a bipartisan, fully bipartisan, nonpartisan product, and it will be. So I look forward to working with you specifically, but also with your colleagues on your side of the aisle, on both sides of the aisle, to get this job done.

Senator Wirth?

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you very much, Mr. Chairman.

I was pleased to join you, and I want to thank you for operating quickly on this issue. It is very important that we move and, Mr. Glauber, we are pleased to have you here today.

As you know, Mr. Chairman, I have been working on a number of issues related to the way in which we are dealing with the S&L crisis and today will be introducing legislation which I hope will begin to set a template for how we can streamline the RTC and streamline the regulatory authorities that you all have which, as we have discussed, are very complicated and I think ought to be streamlined.

It will begin to move us—in the second part of that legislation—it will begin to move us toward functional regulation, which we all have talked about and which ought to be done.

Third, it will institutionalize the fraud units that we have talked about in the past.

Fourth, it will provide authority to the RTC to transfer property of significant natural or cultural values to Federal or State agencies.

I will be introducing that legislation today, Mr. Chairman. Obviously that is not going to pass in this Congress, but I wanted to have it out there for us all to be looking at between now and the time that the new Congress comes in next January. Clearly we are going to be spending a lot of time on this issue.

On the subject of today's hearing, Mr. Glauber, I am particularly interested in your comments on the recent CBO study which indicates that insurance premiums would have to increase to 43 cents per $100 in deposits, more than triple the current rate, to build the

Bank Insurance Fund to the level mandated by FIRREA, 1.25 percent of insured deposits by 1995.

CBO suggested, I believe, that an increase of this magnitude could—and I say "could" not "would"—could put as many as 40 large banks into insolvency and bankrupt the Fund.

Does the Treasury agree with the CBO study?

What are the implications of that?

If those are correct, what other steps ought to be taken to shore up the insurance fund other than what would appear to be some pretty drastic increases in insurance premiums?

I am sure you will be addressing all of that today.

Thank you for being here, Mr. Chairman, and thank you for moving as rapidly on this as we must.

The CHAIRMAN. Thank you, Senator Wirth.

Senator Shelby?

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, let me start by commending you first for introducing your bill to take the caps off the deposit insurance premiums that the FDIC is permitted to charge; and, second, for scheduling this morning's hearing so we might discuss here in the open your proposal and the Treasury's proposal.

I am a cosponsor, Mr. Chairman, of your legislation and obviously share your opinion that it is essential that we provide flexibility to the FDIC in their efforts to restore the Bank Insurance Fund to a sound level. The FDIC recently announced a large increase in premiums, thus sending a loud signal that all is not well in the banking industry. The General Accounting Office and the Congressional Budget Office in testimony before this very committee affirmed that analysis.

I have found in discussions with bankers in my State that most institutions would prefer to pay higher premiums now in advance of a real crisis than suffer the type of punitive legislation that the savings and loan industry has had to undergo.

Mr. Chairman, they would also prefer a more equitable deposit insurance system. As an industry, the banks in my State are extremely well capitalized for their size and are very conservatively managed. The banks in Alabama do not pose the same type of risk to the insurance fund as banks with more aggressive lending practices.

The banks in my State of Alabama, as a rule, do not lend to Third World countries or leverage buy-out artists. Thus, while I support the kind of legislation that we are discussing today, I believe it is only a short-term fix. This committee, I believe, must come back in January prepared to tackle deposit insurance issues in a more comprehensive fashion, Mr. Chairman, as you have laid out in testimony here.

The legislation you dropped in yesterday I believe is an excellent blueprint with which we can work. I also look forward to what the Treasury has to say on this subject.

The CHAIRMAN. Very good, Senator Shelby.

Senator Dixon?

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, today's hearing is an extremely important one, and I want you to know that I share your desire to enact legislation removing the restrictions on FDIC's ability to raise premiums as needed to maintain the safety and soundness of the Bank Insurance Fund. We cannot afford to adjourn this year, in my view, without enacting this vital legislation.

I also want you to know that I agree that this bill should be kept as narrow as possible. Adding other issues jeopardizes our ability to act on this bill in the few remaining days of this session.

I also believe, however, Mr. Chairman, that we need to try to find a way to act on S. 3073, the legislation that Senators Garn, Graham, and I have introduced that puts an additional $2 billion plus each year into the Bank Insurance Fund. I think the need for these additional funds is beyond dispute. The Bank Insurance Fund is clearly under stress. I have great admiration for the Chairman of the FDIC, Bill Seidman. I do not want to see the Chairman faced with inadequate resources so that he is not able to promptly close insolvent institutions when they need to be closed. The FSLIC kept insolvent institutions open for long periods of time in no small part because its fund balance was simply too low.

Essentially FSLIC kept bankrupt S&L's open in order to avoid bankrupting the FSLIC fund. We cannot afford to risk any possibility of a repetition of that terrible mistake. We know where that leads—to hundreds of billions in taxpayers' losses.

Chairman Seidman has also made clear that increasing premiums by itself can reach a point where it is self-defeating, where further premium increases causes more banks to fail. Banks have to improve their capital position. That is one of the objectives of my deposit insurance reform bill. It is also one of the objectives of course of the chairman's bill.

We need to take every action we can therefore that adds to the insurance fund's resources without adding to the risk of additional failures. S. 3073 does that, without adding to the Federal deficit, Mr. Chairman.

I hope that we can act on this legislation this year, and I think it provides another source of support for the insurance fund that we really require.

Finally, I want to remind everyone that taking strong, timely action in this area will enhance confidence in our financial system and will save money. We do not often have the opportunity to take win-win actions, and this is one of those few times. We should not let it go by, and I congratulate the Chair.

The CHAIRMAN. Thank you, Senator Dixon.

I want to say to you, and to Senator Shelby and Senator Wirth who just spoke, that I very much appreciate the initiative being shown by all the members of the committee in trying to develop ideas and approaches to strengthen our banking system.

I have incorporated a large part of the legislation that you have drafted in my bill. It has been very helpful in that regard. I think that we are making progress, and I think we need to continue to press ahead.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. I have a prepared opening statement I would like to file for the record.

The CHAIRMAN. We will make it part of the record.

OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. My focus at today's hearing is going to be on what should be our October agenda. I do not believe that we can afford to wait until the new year in order to take some important steps unless we are prepared to repeat the lessons of 1988 in 1990.

I also am concerned that we need to go beyond lifting the current legal restriction on FDIC premiums.

Four other areas that I believe should be seriously considered for the October agenda would be:

First, is the current working capital in FDIC sufficient in order to allow it to liquidate those institutions who deserve such action and not be drawn into a repetition of the 1988 transactions? The General Accounting Office testified recently before us and agreed to undertake a quick study of that issue. We had representations from representatives of the regulators that there is sufficient working capital at least for the immediate future. I want to be reassured on that point.

Second, is there adequate supervision of the institution so that we have an early warning signal if there are problems? Again, the GAO is conducting a quick study on that issue.

We will be reviewing that again during the process of the appropriations process.

A third issue is a separation of the chartering and underwriting function as it relates to national banks. Currently the FDIC has the authority to remove insurance from State institutions and thrifts.

It does not have that authority to do so from national banks. That authority has been requested by Mr. Seidman. I believe that we ought to make it available to him now.

And fourth is the question of risk-based insurance premiums. I believe that when the history of the thrift debacle is written that a major chapter will be on the fact that we privatize profits and socialized losses by not having an insurance fund but a subsidy fund, and that that subsidy fund was because the insurance "premiums," so-called, did not relate to the real risks that they were imposing. I believe that at a minimum we ought to authorize FDIC by regulatory process to commence the development of regulations for risk-based premiums, and that that should start immediately so that it could be in place at the earliest possible date.

Mr. Chairman, those are some of the items that I think should be considered for the October agenda, and I look forward to the comments of the witnesses today on those and the other items that will be discussed.

Thank you.

[The complete prepared statement of Senator Graham follows:]

PREPARED STATEMENT OF SENATOR GRAHAM

Mr. Chairman, let me congratulate you on holding today's hearing on the bill to give the FDIC the authority to raise the insurance premium cap when the FDIC believes it is necessary to protect the deposit insurance fund.

However, I believe this is just one item of four that we should pass before the Congress adjourns in October to protect our nation's bank insurance fund. The other three items we should pass are to:

First. Authorize the FDIC to provide a risk based insurance premium structure.

Second. Authorize the FDIC to deny insurance to federally chartered and state chartered member banks. This was requested by Chairman Seidman in testimony before the committee on July 31.

Third. Finally we need to provide more working capital to the FDIC for the next 12 months to meet their needs.

Mr. Chairman we're seeing eerie similarities to the early warning signs in the S&L crisis. We should act on these four points Mr. Chairman so we don't wait until crisis forces us to act. We must act now, before adjournment.

The CHAIRMAN. Thank you very much, Senator Graham.

I share many of your concerns in this area.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, let me commend you for today's hearing.

Certainly the taxpayers want to avoid another debacle.

I think we have all the elements for that in terms of what the economy is doing, what the condition of the banking community is in, what the world market conditions are telling us, and so to whatever extent we can I certainly think we have an opportunity to do a better job than what has been the case in the past as it relates to the thrifts.

So I would hope that we would at least be in a position to cushion some of the shock and to let the American public know what we are dealing with—because I think their outrage comes from as much in the way of how could we be having such an incredible problem costing them hundreds of billions of dollars, and apparently no one knows until the bomb explodes. Well, here we have a warning.

I do not think that we are going to escape or the taxpayer is going to escape, to be quite candid with you, but certainly if we can cushion that or minimize those risks and eliminate the possibility of it being the kind of impact that we have seen in the past, that is certainly something that we should be working to do.

I do not think we should hold out and tell the people we know that under no circumstances are we going to have losses, because I am not so sure that we will not go to the taxpayers one way or the other, but certainly we ought to get ahead of this problem and cushion what would otherwise be devastating.

Mr. Chairman, I am going to ask that the text of my remarks, the full text, be placed in the record as if read in its entirety so we do get a chance to hear from our witnesses.

[The complete prepared statement of Senator D'Amato follows:]

PREPARED STATEMENT OF SENATOR D'AMATO

Mr. Chairman, thank you for convening this hearing today on S. 3045, legislation giving added authority to the FDIC to raise deposit insurance premiums. As an original cosponsor of this legislation, I take this opportunity to commend the chairman for his excellent work in crafting S. 3045.

I am pleased to welcome today's witnesses, the Honorable Robert R. Glauber, Under Secretary of the Finance for the Department of Treasury; Mr. John F. Bovenzi, Deputy to the Chairman of the Federal Deposit Insurance Corporation; and Mr. Donald H. Chapin, Assistant Comptroller General in the Accounting and Financial Management Division of the U.S. General Accounting Office. I look forward to hearing their testimony, and so I shall be brief in my opening remarks.

Action is required now to ensure that a taxpayer bailout of the banking system will not be the encore to the savings and loan crisis.

The taxpayers of the United States will not tolerate paying for another multibillion-dollar bailout of unstable and ailing financial institutions. Restoring the Bank Insurance Fund now is the best course for protecting banks, depositors, and taxpayers.

A representative of Standard and Poor's recently testified to this committee that in the last 6 months S&P has lowered its ratings of 36 U.S. bank holding companies, some more than once, and upgraded only 4—a record number of downgrades for S&P. Meanwhile, testimony from the Congressional Budget Office indicates the condition of the Bank Insurance Fund has declined as the industry's health has declined. In the words of the General Accounting Office in its September 1990 report to Congress, the BIF is "too thinly capitalized to deal with the potential for bank failures in the event of a recession."

As the banking situation grows more severe and as we move to address the emerging critical banking issues, various plans containing elements of workable solutions will emerge from the Congess and the administration.

I hope to hear the views of each of today's witnesses on S. 3045 and other methods or approaches they consider worthwhile and workable in the current situation.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Bond?

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you very much, Mr. Chairman.

I certainly agree with the basic thrust of your proposal and that of the Treasury's. We are delighted to see Mr. Glauber here, because I think that protecting the taxpayer and limiting the Government's exposure to risk of bank failures is an extremely important priority for us.

There are many additional issues that we will be addressing, if not this year at least next year, and I believe the Chairman's bill has brought to our attention some of those.

I would note also that the Chairman of the House Banking Committee has proposed a revolutionary change in regulatory structure. We on the Banking Committee have the pleasure of having jurisdiction over the SEC, maybe sometimes over the CFTC, the Fed, the OTS, the FDIC, the OCC, the NCUA, plus looking at what 50 State bank regulators, 50 State insurance—NCAA, if—[Laughter.]

If my colleague from Nevada were here, we would talk about our NCAA bill, but it fits right in with all of that. [Laughter.]

But I note that we have had foreign bankers here in Washington these past several days. Most of those countries have a Ministry of Finance with broad supervisory authority over financial markets and financial products. They cannot understand our system and keep asking why we do it.

We have tried to explain the basic historical precedents, but they keep asking the question: Does this system work?

I think we have to be able to answer that question in the affirmative if we are to provide an effective answer to them and the answer that our citizens deserve.

Having been involved recently in the battle over the question of margins for stock index futures and the, one might say, the turf battles between the SEC, the CFTC, and a number of different groups that are directly interested, I can tell you that I have a low threshold of pleasure and I have enjoyed almost as much of that as I can stand. [Laughter.]

We have a very heavy responsibility to the citizens of our country to get beyond the narrow interests of various groups to shore up the financial system in this country. It is in the national interest. We cannot afford to let legions of bank lobbyists running up billable hours conduct turf wars and be the sole determiners of our banking policy.

Our economy will be at a severe disadvantage going into global economic competition the remainder of this century and in the 21st century if we fail to act to modernize our financial system.

And finally, with respect to the specific question of the deposit insurance premiums, I think a fundamental issue that we cannot afford to lose in the waves of anxiety sweeping the capital over the safety of the Bank Insurance Fund is that we have to look at why there are losses in the banking industry.

Raising the premiums and capital requirements without looking at the underlying causes for rising bank failure rates is a pointless exercise. If banks cannot make money, they cannot meet the requirements, they cannot raise the capital, and they cannot generate the profits needed to pay the premiums and to keep themselves and the system strong.

Bank charters are not what they once were. They are not worth as much. They do not give you an automatic license to print profits. The banks used to have a monopoly on deposit-taking and lending businesses. Competition can be good for the consumer, provided we have healthy competitors, and I think we have to keep that in mind as we look at these questions.

I thank the Chair.

The CHAIRMAN. Thank you, Senator Bond.

Mr. Glauber, as you can see from the comments and the participation this morning, there is a great interest in this subject. So we are looking forward to your comments. We will make your full statement a part of the record, and we would like to hear your summary comments now.

STATEMENT OF ROBERT R. GLAUBER, UNDER SECRETARY FOR FINANCE, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. GLAUBER. Very good. Thank you, Mr. Chairman.

Let me just at the outset underline several statements you made in your opening remarks. We have always enjoyed a very cooperative working relationship with you and your committee, and we look forward to continuing to do that both on this narrow legislation that deals with flexibility for the FDIC in setting assessments rates, and the more broad issues that are raised in part in legislation you just recently submitted.

Also I would like to say to Senator Garn that we agree that it is very useful to this dialog that these various legislative alternatives be submitted. I think it provides a basis for discussion.

We agree that this is an issue that needs to be addressed soon, and as quickly in the next Congress as possible. In that effort, we have committed to get our deposit insurance study done several months early, before the end of this year. Also today, as you will see in my remarks, we have tried to give you some indication of where we are headed in certain aspects of the deposit insurance study.

If it is all right with you, then, Mr. Chairman, I would like to read some excerpts from my full statement.

The **Chairman**. Please do.

Mr. **Glauber**. Chairman Riegle, Senator Garn, members of the committee:

Thank you for the opportunity to provide the administration's views on legislative proposals to provide immediate assessment flexibility to the Federal Deposit Insurance Corporation.

These include the administration's proposal, the Deposit Insurance Fund Flexibility Act of 1990; the Senate bill S. 3045, which is sponsored by you, Mr. Chairman; and the House bill that was passed last week.

While we support the basic provisions of both the Senate and the House bills, we believe the administration's approach provides important additional flexibility to the FDIC. Indeed, some of that flexibility is along the lines of comments made by Mr. Dixon and Mr. Graham in their opening statements.

We therefore urge its prompt enactment since, along with capital, the insurance funds are a crucial buffer that stands between the taxpayer and losses of insured banks and thrifts.

Before describing our views in detail, let me emphasize that the administration's bill is not intended to supplant the Treasury's deposit insurance study which is mandated by FIRREA. This study will produce comprehensive recommendations on deposit insurance reform, and Congress is likely to further scrutinize this complex issue before taking any action.

In the meantime, it is important that the FDIC have the assessment and borrowing flexibility included in the administration's bill. At the same time, our deposit insurance study continues to move forward, and we expect to provide recommendations by the end of the year.

As part of this effort, we have been following the deposit insurance hearings in this committee and in the House of Representatives with great interest. We believe that some of the early recommendations growing out of these hearings have been constructive, including, of course, the bill that you introduced yesterday, Mr. Chairman.

I thought I might conclude our testimony today with a brief discussion of some of the attractive options that are emerging from our own study. Let me now turn first to the specific details of the assessment legislation.

As you know from the testimony by the FDIC, the bank regulators, the GAO, the CBO, and others, the Bank Insurance Fund is indeed under stress. Reserves declined from $18.3 billion at the end of 1987 to $13.2 billion at the end of 1989, and the FDIC expects a further decline of at least $2 billion this year.

The reserve to insured deposit ratio has experienced a corresponding decline to the lowest level in the history of the fund. At the same time, the banking industry profits have weakened and the bank balance sheets include three principal areas of exposure:

commercial real estate loans, loans to less developed countries and, to a lesser extent, loans for highly leveraged transactions.

Real estate exposure is a particular concern in view of soft real estate markets in different regions of the country. Despite these problems, it would be incorrect to suggest that the banking industry is in the same condition as the thrift industry. Banks have much more tangible capital than thrifts and, until FIRREA's improvements to thrift regulation, banking regulation was considerably better than thrift regulation.

Moreover, banks have generally been prohibited from engaging in the riskiest of thrift activities, including direct investment in real estate, equities, and junk bonds, and they have not been permitted to engage in the rapid growth that caused such staggering losses in the thrift industry.

Still, the adverse trends in both the banking industry and the Bank Insurance Fund are clear causes for concern. While the Treasury Department does not directly regulate the banking industry, we have had detailed discussions with the bank regulators and the FDIC. We believe there is general agreement that Congress should take steps to provide the FDIC with the flexibility to meet the potential contingency needs of the Bank Insurance Fund.

Let me now turn to the administration's assessment bill which addresses this concern. When the administration introduced FIRREA almost 2 years ago we strongly endorsed the concept that the FDIC should operate the deposit insurance funds in a manner much more similar to private insurance companies. That required changes in the law to provide the FDIC with greater flexibility to establish assessment rates and rebates, much the way a private insurance company assesses premiums and pays out dividends.

Congress generally embraced this concept, but more restrictive limitations were imposed on the FDIC's assessment authority than had been introduced in the administration's bill. In addition, automatic rebates and dividend triggers were enacted to constrain the FDIC's ability to build up reserves in the fund for future periods of unusual stress.

In a nutshell, the administration's proposal before you today would remove these constraints and help the FDIC take additional steps toward the private insurance model envisioned by FIRREA.

Our bill would provide the FDIC with broad discretion to set assessments, rebates, and dividends of the funds. It also includes a specific provision stating that the FDIC is permitted to borrow from Treasury's Federal Financing Bank, but only for liquidity or working capital purposes. The FFB provides a less expensive and more flexible alternative to FDIC notes with identical budget impact but would not be used to expand the ability of the FDIC to pay for actual fund losses.

Each of these elements of the administration's bill is described in detail in my written statement.

Let me stress that the FDIC's new authority could not be exercised arbitrarily. It would still be specifically required to take into account the effect of any rate increase on the earnings and capitalization of insured institutions.

It would be counterproductive if the revenue from an increased assessment were offset by losses from insolvency caused by that increase, or if an increase caused a substantial weakening of the industry's capital or ability to attract capital.

Let me also make one other point. Much criticism has been leveled at our proposal to eliminate mandatory rebates and dividends which we think does indeed make sense. The FDIC calculates that if rebates had not been distributed to the banking industry over the last 50 years, the Bank Insurance Fund would now have an additional reserve level of over $30 billion, and we would probably not need to have this hearing today.

In sum, the three legislative proposals before Congress—the administration's bill, the Senate bill, and the House-passed bill—provide differing levels of flexibility to the FDIC. The administration supports all three approaches.

The Senate bill provides assessment flexibility to the FDIC for the Bank Insurance Fund alone where it is most needed in the near-term.

The House bill includes the Senate approach and extends the assessment flexibility to thrifts, which we believe is appropriate.

Finally, the administration's bill provides additional flexibility for rebates, dividends, and borrowing, which is supported by the FDIC.

The administration believes that this type of legislation should be passed before Congress adjourns, and indeed in that sense we agree with virtually all the opening statements that were made.

We hope to work with both the Senate and the House to accomplish this goal. Let me emphasize, however, that we do not seek to transform this legislation into a vehicle for broader deposit insurance reform or other controversial legislation. That would be a mistake.

When the administration introduced FIRREA in the beginning of 1989, we included the deposit insurance study to ensure that there would be a thorough examination of reforms that would be finished in time for full consideration by the next Congress.

We also believe that deposit insurance cannot be adequately addressed without addressing the linked and equally complex issue of financial services restructuring. That should wait until next year.

Let me now turn to broader deposit insurance issues.

Chairman Riegle, I have only briefly reviewed the deposit insurance proposal you introduced yesterday, but like the comprehensive proposal put forth by Chairman Gonzalez, we welcome constructive efforts to advance the debate. This should help us get a fast start on next year's legislation, which is exactly why we have moved up the completion date of our own study to the end of this year.

While it would be premature to set forth our comprehensive recommendations on the broader deposit insurance issues such as how to address "too big to fail," or the restructuring of bank activities and regulation, there are a number of specific areas where we have begun to lean towards specific conclusions.

Before discussing these, let me first provide some general background:

The historic purpose of deposit insurance is to protect the savings of small depositors. Along with other aspects of the Federal safety net, deposit insurance prevents destructive bank runs and helps maintain confidence in the banking system, but it also removes market discipline that would otherwise constrain banks from taking excessive risk.

Moreover, without limitations, deposit insurance and the Federal safety net can attract too much money into the banking system. Indeed, deposit insurance has moved away from its roots—the protection of small investors—to the point where new pass-through deposit vehicles allow sophisticated investors to shift funds from private markets to full safety net coverage. The result is that more funds can become available than banks can wisely invest in prudent loans.

This can produce risky and unproductive investments that distort and ultimately depress the economy. The key to deposit insurance reform is to strike a balance between two ends of the spectrum: to maintain enough depositor confidence in the banking system to avoid destructive bank runs, while at the same time restraining banks from taking excessive and unproductive risks.

Our current system for accomplishing this is to balance deposit insurance with government supervision and capital requirements, but that system has not worked as well as it should—especially in the thrift industry.

At this time, we see five general avenues for deposit insurance reform under which most recommendations fall:

One, adjustments of deposit insurance scope and structure;

Two, increased capital;

Three, restrictions on safety net activities;

Four, restrictions on funds flowing into the safety net; and

Five, improved supervision.

We expect our study to provide recommendations in each of these categories. Today let me just briefly describe several options that we currently find particularly attractive, although they are by no means exhaustive:

The first category includes proposals that would adjust both the pricing and scope of deposit insurance. With respect to pricing, we support the general concept of risk-based premiums. Our current flat-rate deposit insurance system not only removes market discipline on risk in general, but it actually encourages banks to engage in riskier activities because there is no additional cost of doing so.

Appropriately priced risk-based premiums would correct this anomaly, and it is the concept that was embraced in the 1984 report of Vice President Bush's Task Force on the Regulation of Financial Services.

Likewise, we remain attracted to the idea of limiting the number of insured accounts per depositor. The historic purpose of deposit insurance was to protect the small depositor who was not apt to require more than a limited number of insured accounts. Depositors with the means to establish multiple hundred thousand dollar accounts should be in less need of Federal protection and more in a position to exercise market discipline about the soundness of depository institutions.

And although the administrative problems of this proposal are formidable, they do not appear insurmountable. Nevertheless, the effectiveness of this proposal will depend on adjustments to the "too big to fail" policy where uninsured accounts are frequently protected in large bank failures.

The second major category is increased capital, which this administration has consistently favored for both banks and thrifts. Increased capital is a direct protection for the deposit insurance fund and directly counters the moral hazard and lack of market discipline caused by deposit insurance. The corollary of course is that we avoid restrictions that deter capital investment in banks and thrifts.

The third category is restrictions on the safety net activities which restrict the activities or powers of institutions that have direct access to Federal deposit insurance and the Federal safety net. In general, we believe that riskier, nontraditional banking activities should be moved to or take place in separately capitalized subsidiaries or affiliates.

In addition, two areas appear to require specific action.

First, real estate lending standards must be reviewed in detail for insured depositories. Too much of the losses in both banks and thrifts relate directly to commercial real estate lending where underwriting standards have changed substantially over the last 20 years.

A review might produce recommendations for both statutory and regulatory changes.

Second, as we learned too well from the thrift crisis, State powers backed directly by Federal deposit insurance can be a formula for disaster. FIRREA addressed this problem for the thrift industry with a flexible, common sense approach that could be applied to the banking industry.

Unlike the previous category which focused on the asset side of the bank balance sheet, proposals in this fourth category—that is, restrictions on funds flowing into the safety net—focuses on the liability side.

That means that excess funds in the banking system can chase too few opportunities creating riskier loans with losses covered by the safety net. This requires careful consideration of limitations on pass-through accounts that have the ability to attract massive amounts of funds into the umbrella coverage of the Federal safety net.

Supervision, which is the fifth topic, is already a primary tool for preventing excessive risk in insured depositories, but improvements can and should be made. We are focusing on two specific supervisory issues.

The first is staged intervention. Like the Federal Reserve, we generally favor the concept of more formalized supervisory actions triggered by declines in capital levels. Problems can be identified and addressed more quickly with strong incentives to maintain safe levels of capital.

Costly forbearance policies would be minimized. Most important, an effective policy of staged intervention should maximize the ability to resolve failing institutions at the least cost to the deposit insurance funds and the taxpayer.

Second, we believe that there is no effective substitute for annual, on-site examinations at least once a year for both large and troubled institutions. Too many problems can occur too quickly, and the early intervention concept requires close, on-site attention to emerging problems.

Let me conclude with just three points:

First, the deposit insurance options we have listed are neither exhaustive nor our final conclusions. They are meant only to help begin this debate early and constructively.

Second, while the administration and Congress proceed with determination to address these issues, we must resist the temptation to overreact. The momentum now suggests that any proposed restriction on banks and thrifts, no matter how onerous, is fair game. That attitude must be avoided because the consequences could be clearly counterproductive. No one wants that.

Finally, we cannot lose sight of the need to modernize our financial services system to remain competitive. Contracting the safety net to insured depositories is crucial, but so is broadening the range of permissible financial activities of affiliates of banks acting outside the safety net as well as relaxing geographic restrictions on banks. I believe that some combination of these steps will ultimately provide the best protection to the deposit insurance funds and to the taxpayer.

Mr. Chairman, that concludes my statement. I would be pleased to answer any questions you and the committee might have.

[The complete prepared statement of Robert R. Glauber follows:]

TESTIMONY OF THE HONORABLE
ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS

September 26, 1990

Chairman Riegle, Senator Garn, and members of the Committee, thank you for the opportunity to provide the Administration's views on legislative proposals to provide immediate assessment flexibility to the Federal Deposit Insurance Corporation (FDIC) to protect the solvency of its deposit insurance funds. These include the Administration's proposal, S.3093, the "Deposit Insurance Funds Flexibility Act of 1990"; the Senate bill, S.3045, which is sponsored by you, Mr. Chairman; and the House bill, H.R. 5610, the "Deposit Insurance Funds Protection Act of 1990," which was passed last week by the House of Representatives.

While we support the basic provisions of both the Senate and House bills, we believe the Administration's approach provides important additional flexibility to the FDIC. We therefore urge its prompt enactment since, along with capital, the insurance funds are a crucial buffer that stands between the taxpayer and losses of insured banks and thrifts.

Before describing our views in detail, let me emphasize that the Administration's bill is not intended to supplant Treasury's deposit insurance study, which is mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). This study will produce comprehensive recommendations on deposit insurance reform, and Congress is likely to further scrutinize this complex and controversial topic before taking any action. In the meantime, it is important that the FDIC have assessment and borrowing flexibility. The Administration's bill provides this interim flexibility.

At the same time, our deposit insurance study continues to move forward, and we expect to provide recommendations by the end of the year. As part of this effort we have been following the deposit insurance hearings in this Committee and in the House of Representatives with great interest. We believe that some of the early recommendations growing out of these hearings have been constructive, including the bill you introduced yesterday, Mr. Chairman, and I thought I might conclude our testimony today with a brief discussion of several of the attractive options that are emerging from our own study.

Let me now turn to the specific details of the assessment legislation.

The Condition of the Bank Insurance Fund

As you know from testimony by the FDIC, the bank regulators, the General Accounting Office, the Congressional Budget Office, and others, the Bank Insurance Fund is under stress. Reserves declined from $18.3 billion at the end of 1987 to $13.2 billion at the end of 1989, and the FDIC expects a further decline of at least $2 billion this year. The reserves-to-insured deposits ratio has experienced a corresponding decline to the lowest level in the history of the fund, and will decline further by the end of the year.

At the same time, banking industry profits have weakened, and bank balance sheets include three principal areas of exposure: commercial real estate loans; loans to less developed countries; and, to a lesser extent, loans in highly leveraged transactions. Real estate exposure is a particular concern in view of soft real estate markets in different regions of the country.

Despite these problems, it would be incorrect to suggest that the banking industry is in the same condition as the thrift industry. Banks have much more tangible capital than thrifts, and until FIRREA's improvements to thrift regulation, banking regulation was considerably better than thrift regulation. Moreover, banks have generally been prohibited from engaging in the riskiest of thrift activities -- including direct investment in real estate, equities, and junk bonds -- and they have not been permitted to engage in the rapid growth that caused such staggering losses in the thrift industry.

Still, the adverse trends in both the banking industry and the Bank Insurance Fund are clear causes for concern. While the Treasury Department does not directly regulate the banking industry, we have had detailed discussions with our bureau, the Office of the Comptroller of the Currency (OCC), which regulates national banks, and with the FDIC and the Federal Reserve, which regulate state banks and bank holding companies. We believe there is general agreement consensus that Congress should take steps to provide the FDIC with the flexibility to meet the potential contingency needs of the Bank Insurance Fund. The Administration's assessment bill, discussed below, addresses this concern.

The Administration's Assessment Legislation

When the Administration introduced FIRREA almost two years ago, we strongly endorsed the concept that the FDIC should operate the deposit insurance funds in a manner much more similar to private insurance companies. That required changes in the law to provide the FDIC with greater flexibility to establish assessment rates and rebates, much the way a private insurance company assesses premiums and pays out dividends. Congress generally embraced this concept, but more restrictive limitations were imposed on FDIC assessment authority than had been included in the Administration's bill. In addition, automatic rebate and dividend triggers were enacted that constrain the FDIC's ability to build up fund reserves for future periods of unusual stress.

In a nutshell, the Administration's proposal before you today would remove these constraints to help the FDIC take additional steps toward the private insurance model envisioned by FIRREA. The "Deposit Insurance Funds Flexibility Act of 1990" would provide the FDIC with broad discretion to set assessments, rebates, and dividends of fund reserves. It also includes a specific provision stating that the FDIC is permitted to borrow from Treasury's Federal Financing Bank (FFB), but only for liquidity or working capital purposes. The FFB provides a less expensive and flexible alternative to FDIC notes, with identical budget impact, but would not be used to expand the ability of the FDIC to pay for actual fund losses. Each of these elements of the Administration's bill is described below.

Assessment Flexibility. The bill removes four constraints on FDIC assessment authority for both insured banks and thrifts: the annual limitation on assessment increases of .075 percent of deposits; the overall cap on assessments at .325 percent of deposits; the prohibition on increasing rates so long as the fund is increasing; and the requirement that rate changes can only be made annually, rather than semiannually.

Let me stress that this new authority could not be exercised arbitrarily -- the FDIC would still be specifically required to take into account the effect of any rate increase on the earnings and capitalization of insured institutions. It would be counterproductive if the revenue from an increase in assessments were offset by losses from insolvencies caused by the increase, or if an increase caused a substantial weakening of the industry's capital or ability to attract capital.

These changes in assessment authority included in the Administration bill are similar to the changes proposed in both the Senate and House-passed bills, except that the Senate bill does not apply to thrifts. We believe that the new discretion should apply equally to thrifts and banks, although again, the FDIC would be required to weigh carefully the potentially counterproductive costs of increasing thrift premiums in the near-term beyond the schedule prescribed in FIRREA.

Rebate Flexibility. Current law constrains the FDIC's ability to prevent rebates of assessments to insured institutions under certain circumstances. Specifically, FIRREA sets the "designated reserve ratio" -- the ratio of fund reserves to insured deposits -- at 1.25 percent. This reflects a judgment about the minimum size of the fund, and the FDIC is authorized to raise the designated reserve ratio if it is justified by circumstances "that raise a significant risk of substantial future losses to the fund." Once the fund exceeds the designated reserve ratio, the FDIC is required to rebate assessments to insured institutions.

This scheme would make sense if the FDIC had maximum discretion to raise the designated reserve ratio, but it does not -- current law prohibits the ratio from exceeding 1.50 percent. Rebates are therefore mandatory at that level in virtually all circumstances.

This is not sound public policy because we cannot say with assurance that 1.50 percent will always be a safe maximum ratio for the funds. The appropriate ratio could vary depending on a number of circumstances, including the structure and riskiness of the industry, which is likely to change over time. Moreover, the FDIC should have the flexibility to set aside reserves for future periods of unanticipated stress.

Let me illustrate my point: the FDIC calculates that if rebates had not been distributed to the banking industry over the last 50 years, the Bank Insurance Fund would now have additional reserves of over $30 billion -- and we would probably not need to have this hearing today.

In short, we believe the FDIC should provide appropriate rebates, but only on a discretionary basis. The Administration's bill therefore removes both the absolute cap on the designated reserve ratio and mandatory rebate requirements. Neither the Senate bill nor the House-passed bill includes this provision.

Dividend Flexibility. FIRREA also constrains the FDIC's ability to keep and reinvest the income earned on fund reserves. Once the fund reaches the reserve ratio of 1.25 percent, interest earned on additional fund reserves must be paid out as dividends to insured banks or thrifts. This obviously limits the speed with which the fund can accumulate reserves. Just as there is no justification for choosing 1.50 percent as the level at which rebates should be automatic, there is no justification for choosing 1.25 percent as the level at which dividends should be automatic.

The Administration's bill removes this limitation, leaving dividend policy to the discretion of the FDIC. Neither the Senate bill nor the House-passed bill includes this provision.

Borrowing Flexibility. The FDIC is increasingly facing liquidity or working capital constraints in failed bank transactions. An acquiring bank sometimes chooses not to acquire the illiquid assets of a failed bank, and the FDIC must then purchase these assets and resell them to the private sector. That resale process can be lengthy, and can tie up the FDIC's cash resources in illiquid assets for extended periods of time.

Since the FDIC needs cash to resolve other failed banks, it must resort to borrowing against its illiquid assets to obtain that cash.

FIRREA addresses these circumstances, just as it does for the Resolution Trust Corporation, by imposing a borrowing or obligation cap. The FDIC may borrow against illiquid assets, but only so long as it maintains an unencumbered reserve or net worth of at least 10 percent of total assets. This net worth cushion can absorb losses if acquired assets are sold for less than originally estimated. It is designed to prevent the FDIC from using its borrowing authority to spend more than it actually has.

The problem is that the FDIC now uses an expensive means to borrow -- it issues FDIC notes directly to acquiring banks, and these notes carry significantly higher interest rates than traditional government borrowing. At the same time, acquiring banks do not always wish to accept FDIC notes in lieu of cash because the notes are not transferable.

The Administration believes that the FDIC should take advantage of lower government borrowing rates if it chooses to borrow, which it could accomplish by borrowing from Treasury's Federal Financing Bank. This would provide flexibility to the FDIC, and lower borrowing costs would prevent unnecessary reductions in the fund's net worth, which is the cushion between the taxpayer and losses of insured institutions. Put another way, we believe that the FDIC should have all the flexibility it requires to engage in least cost transactions, rather than least cash transactions.

The budget treatment of FDIC borrowing from the FFB would be identical to the current budget treatment of FDIC notes -- both transactions would be scored as outlays. Likewise, FFB borrowing would be fully subject to FIRREA's obligation cap on the FDIC, which guards against the FDIC using borrowing to pay for losses to the fund.

While we believe the FDIC already has the authority to borrow from the FFB under the Federal Financing Bank Act, the FDIC disagrees. Without resolving this question, the Administration's bill expressly states that the FDIC does have FFB borrowing authority under the Federal Deposit Insurance Act, a provision which the FDIC supports. Neither the Senate bill nor the House-passed bill includes a similar provision that would provide this borrowing flexibility.

In sum, the three legislative proposals before the Congress -- the Administration's bill, the Senate bill, and the House-passed bill -- provide differing levels of flexibility to the FDIC. The Administration supports all three approaches. The

Senate bill provides assessment flexibility to the FDIC for the Bank Insurance Fund alone, where it is most needed in the near-term. The House-passed bill includes the Senate approach and extends the assessment flexibility to thrifts, which we believe is appropriate. Finally, the Administration's bill provides additional flexibility for rebates, dividends, and borrowing, which is supported by the FDIC.

The Administration believes that this type of legislation should be passed before Congress adjourns, and we hope to work with both the Senate and the House to accomplish this goal. Let me emphasize, however, that we do not seek to transform this legislation into a "vehicle" for broader deposit insurance reform or other controversial legislation. That would be a mistake.

When the Administration introduced FIRREA in the beginning of 1989, we included the deposit insurance study to ensure that there would be a thorough examination of reforms that would be finished in time for full consideration by the next Congress. We also believe that deposit insurance cannot be adequately addressed without addressing the linked and equally complex issue of financial services restructuring.

At the same time, the comprehensive hearings in both this Committee and the House Banking Committee have helped set the stage in a thoughtful, deliberate manner for taking up deposit insurance reform next year. That is as it should be because, as this Committee knows, this is a complex, controversial subject that will demand extensive debate before reforms can be enacted. Acting precipitously could create serious unforeseen consequences.

Broader Deposit Insurance Issues

As I mentioned at the outset, let me conclude my testimony with a "progress report" on our deposit insurance study and some of our current thinking. Chairman Riegle, I have only briefly reviewed the deposit insurance proposal you introduced yesterday, but like the comprehensive proposal put forth by Chairman Gonzalez, we welcome constructive efforts to advance the debate. This should help us get a fast start on next year's legislation, which is exactly why we have moved up the completion date of our own study to the end of this year.

While it would be premature to set forth our comprehensive recommendations on the broader deposit insurance issues -- such as how to address the "too big to fail" problem or the restructuring of banking activities and regulation -- there are a number of specific areas where we have begun to lean towards specific conclusions. Before discussing these, let me first provide some general background.

The historic purpose of deposit insurance is to protect the savings of small depositors. Along with other aspects of the "federal safety net," deposit insurance prevents destructive bank runs and helps maintain confidence in the banking system. Moreover, in its initial stages when there were few competing forms of credit, deposit insurance helped ensure that sufficient funds from savers flowed into banks to be used productively to finance loans throughout the economy. Put another way, without deposit insurance, small savers in the 1930s not only risked losing their savings; they also had an incentive to take their funds out of the banking system altogether and "put it under the mattress," which could have further depressed the economy.

Deposit insurance helped solve these problems, but in doing so it created a different one -- it removed market discipline that would otherwise constrain banks from taking excessive risk. We know from the thrift crisis exactly how disastrous the worst consequences can be: prolonged periods of reckless gambling with depositors money; losses mounting to staggering levels; and the taxpayer stuck with the bill.

Moreover, without limitations, deposit insurance and the federal safety net can attract too much money into the banking system. Indeed, deposit insurance has moved away from its roots -- the protection of small savers -- to the point where new "pass-through" deposit vehicles allow sophisticated investors to shift funds from private markets to full safety net coverage.

The result is that more funds can become available than banks can wisely invest in prudent loans. This can produce risky and unproductive investments that distort and ultimately depress the economy.

The key to deposit insurance reform is to strike a balance between two ends of the spectrum -- to maintain enough depositor confidence in the banking system to avoid destructive bank runs, while at the same time restraining banks from taking excessive and unproductive risk. Our current system for accomplishing this goal is to balance deposit insurance with government supervision and capital requirements. But that system has not worked as well as it should, especially in the thrift industry.

At this time we see five general avenues for deposit insurance reform under which most recommendations fall:

1. Adjustments to Deposit Insurance Scope or Structure
2. Increased Capital
3. Restrictions on Safety Net Activities
4. Restrictions on Funds Flowing Into the Safety Net
5. Improved Supervision

We expect our study to provide recommendations in each of these categories. Today let me describe several of the options that we currently find particularly attractive, although these are by no means exhaustive.

1. Adjustments to Deposit Insurance Scope and Structure

This category includes proposals that would adjust both the pricing and scope of deposit insurance. These measures are intended to reintroduce greater market discipline from depositors or provide substitutes for market discipline. The most important of these proposals involve adjustments to the "too-big-to-fail" doctrine, which is a primary concern for our deposit insurance study. Without resolving that complex question at this time, there are two proposals within this category that we do find promising.

Risk-Based Premiums. With respect to pricing, we support the general concept of risk-based premiums. Our current flat-rate deposit insurance system not only removes market discipline on risk in general, but it actually encourages banks to engage in riskier activities because there is no additional cost to doing so. Appropriately priced risk-based premiums would correct this anomaly, and is a concept that was embraced in the 1984 report of Vice President Bush's Task Group on the Regulation of Financial Services.

We have no illusions about the difficulty of pricing risk or of the problem that changes in fundamental behavior may require large price differentials for different categories of risk. In addition, unlike the up-front cushion required by risk-based capital, risk-based premium schemes often penalize behavior after the fact when an institution is weakened and less able to bear the increased costs. Nevertheless, risk-based premiums can be a useful complement to capital in deterrring excessive risk at the margin. We are also carefully examining a number of the private sector pricing arrangements under coinsurance proposals like the one sponsored by Senators Dixon, Sanford, and Wirth.

Limiting the Number of Insured Accounts. As Secretary Brady testified in July, we remain attracted to the idea of limiting the number of insured accounts per depositor. The historic purpose of deposit insurance was to protect the small depositor, who is not apt to require more than a limited number of insured accounts. Depositors with the means to establish multiple $100,000 accounts should be in less need of federal protection and more in a position to exercise market discipline about the soundness of depository institutions. And although the administrative problems of this proposal are formidable, they do not appear insurmountable. Nevertheless, the effectiveness of this proposal will depend on adjustments to the "too big to fail" policy, where uninsured accounts are frequently protected in large bank failures.

2. Increased Capital

This Administration has consistently favored strong and risk-based capital requirements for both banks and thrifts. Increased capital is a direct protection for the deposit insurance fund and directly counters the moral hazard and lack of market discipline caused by deposit insurance. While the new bank capital standards should be given time to work, adjustments may be appropriate for institutions that seek to affiliate with firms engaged in certain kinds of nonbanking activities. As we have said many times, there is no better incentive for prudent behavior than requiring owners to put substantial amounts of their own funds at risk ahead of the taxpayer. The corollary, of course, is that we avoid restrictions that deter capital investment in banks and thrifts.

3. Restrictions on Safety Net Activities

Included in this category are proposals to restrict the activities or "powers" of institutions that have direct access to federal deposit insurance and the federal safety net (the insured depository, not its affiliates). Many such restrictions on the asset side of a bank's balance sheet are already in place for most banks, including restrictions on securities activities and direct real estate investments. In general, we believe that riskier, non-traditional banking activities should be moved to or take place in separately capitalized subsidiaries or affiliates. In addition, two areas appear to require specific action.

Real Estate Lending Standards. These standards must be reviewed in detail for insured depositories. Too much of the losses in both banks and thrifts relate directly to commercial real estate lending, where underwriting standards have changed substantially over the last twenty years. A review might produce recommendations for both statutory and regulatory changes, including the possibility that certain kinds of real estate lending be conducted in subsidiaries or affiliates.

Restrictions on State Powers. As we learned too well from the thrift crisis, state powers backed directly by federal deposit insurance without adequate federal supervision is a formula for disaster. FIRREA addressed this problem for the thrift industry both with statutory limitations on exceptionally risky activities and by providing substantial authority to the federal regulators to curb excessive state thrift powers. This left room for innovation at the state level, which has been significant, while at the same time protecting the clear federal interest created by federal deposit insurance. While state banks have not experienced the same problems as thrifts, the potential federal liability requires a similar solution.

4. Restrictions on Funds Flowing Into the Safety Net

Unlike the previous category, which focused on the asset side of bank balance sheets, proposals in this category focus on the liability side. The concern here is that the expansion of federal insurance has created far too powerful a magnet for the inflow of funds. The original purpose of deposit insurance was to protect the funds of small savers. It was not to attract massive amounts of funds from sophisticated investors that could just as easily be invested outside the federal safety net.

The problem is that the amount of funds attracted into the banking system may be far greater than the amount that can be deployed wisely in traditional banking assets. This is particularly true since, as Secretary Brady testified in July, more and more of the traditional banking business has migrated to securities markets and nonbank competitors outside the safety net. That means that excess funds can chase too few opportunities, creating riskier loans with losses covered by the safety net. This is one explanation for the series of unwise lending decisions in energy, agriculture, less developed countries, and real estate. Moreover, this problem is particularly troublesome for weak, undercapitalized institutions where the "moral hazard" to take excessive risk is particularly pronounced.

In short, the problem requires careful consideration of limitations on "pass-through" accounts, including brokered deposits, pension plan investments, and bank investment contracts. These accounts all share the ability to attract massive amounts of funds into the umbrella coverage of the federal safety net. Furthermore, restricting the flow of funds into the safety net is an additional reason why the limitation on the number of insured, $100,000 accounts is an attractive option.

5. Improved Supervision

Supervision is already a primary tool for preventing excessive risk in insured depositories. But improvements can and should be made, including through improved accounting and disclosure mechanisms. For example, the Treasury study is specifically considering the feasibility of market value accounting for different parts of the bank's balance sheet. At this time, however, we are currently focusing on two specific supervisory issues.

Staged Intervention. Like the Federal Reserve, we generally favor the concept of more formalized supervisory actions triggered by declines in capital levels. Problems can be identified and addressed more quickly, with strong incentives to maintain safe levels of capital. Costly forbearance policies would be minimized. Most important, an effective policy of staged intervention should maximize the ability to resolve failing institutions at the least cost to the deposit insurance funds and the taxpayer. Indeed, we believe the OCC's policy of closing banks that are insolvent on an equity basis is an important step in this direction. Having said this, the critical tension in adopting a staged intervention policy is to build in adequate flexibility to permit the regulator to make important individual judgments without compromising the entire premise of predictable consequences at particular trigger points.

Annual, On-Site Examinations. We believe that there is no effective substitute for annual, on-site examinations at least once a year for both large and troubled institutions. Too many problems can occur too quickly, and the early intervention concept requires close, on-site attention to emerging problems. This policy may require an increase in resources available to all the regulators.

Conclusion

Let me conclude with three points. First, the deposit insurance options we have listed are neither exhaustive nor our final conclusions. They are meant only to help begin this debate early and constructively.

Second, while the Administration and Congress must proceed with determination to address these issues, we must resist the temptation to overreact. The momentum now suggests that any proposed restriction on banks and thrifts, no matter how onerous and counterproductive, is fair game. That attitude must be avoided because the consequences could be clearly counterproductive. No one wants that.

Finally, we cannot lose sight of the need to modernize our financial services system to remain competitive. Contracting the safety net to insured depositories is critical. But so is broadening the range of permissible financial activities of affiliates of banks acting outside the safety net. I believe that some combination of both of these steps will ultimately provide the best protection to the deposit insurance funds and the taxpayer.

Mr. Chairman, that concludes my testimony.

The CHAIRMAN. Well first of all let me say, Secretary Glauber, that I appreciate what you have said today. It is a very forthcoming statement. I think we are moving generally in the same direction, and I detect a sense of urgency in your remarks comparable to what we feel here.

I think, as well, that the proposal and the ideas that Chairman Gonzalez on the House side has put forward also go in the same direction. There is a lot of thinking here that really dovetails and fits quite well.

Now obviously we are going to have to work out certain details as we go. I think it is very important that this issue be put way up on the administration's priority list and not just as we conclude this year but also as we start the new legislative year.

I know that that is always a contest within any administration because there are multiple priority requests.

Is it your sense that this will be in a short list of top priority items?

Has that decision yet been made?

Mr. GLAUBER. I can assure you that, at Treasury, it is very much at the top of our list of priorities. And I believe, for the administration, it will be, indeed, the same.

I think you know from the statements that Secretary Brady made before this committee in July, we agree with you that these issues must be addressed.

And as I said in my statement, that is why we have advanced the time of our report, so that it can be available and form a basis together with your proposals and others for next year's legislative agenda.

The CHAIRMAN. I think examination and supervision issues aspects have to be a part of the proposal, so I hope that you will continue to work on that.

We did the savings and loan reform bill last year. We put everything else aside in order to get that done.

We will want to consider certain other items that will have to be dealt with. But, I think that we ought, perhaps, to try to clear the track from the beginning of the next legislative year.

This is not to set aside some of the points that Senator Graham makes as to what we might still do this year. There are some things that we hope to do, including the bill that is before us today. But, it seems to me that getting this done and getting the deposit insurance system and the supervisory and regulatory structure squared away is absolutely crucial.

And part and parcel with that are changes in the business charter which is being altered now by regulatory decisions at the Fed and by some court decisions. But, the nature of the financial services business in the future is, obviously, a directly connected counterpart question.

I don't think we can answer those questions until we are sure that we have squared away the deposit insurance system. And it is not squared away today.

Mr. GLAUBER. Mr. Chairman. First, I agree that we really do need to pass this legislation to give greater flexibility to the FDIC. And I hope we will pass it in this session.

On the other issues, I agree with you as well that we ought to consider deposit insurance reform in conjunction with the reform of activities permitted to various financial institutions.

I don't think they can be separated and that is one of the reasons that very early on in our study on the deposit insurance, we made the determination, as we have discussed before this committee before, to include the issue of the reform of financial services as part of the deposit insurance study.

It simply makes no sense to make changes in the deposit insurance system predicated on the current structure of financial services and then move to change those financial service structures and then have to change again the deposit insurance system.

So, I think we need to do both of them together. And we will, indeed, report on both of them.

The CHAIRMAN. The President has some background in this area because he worked in that area during the eighties. If he is willing to engage, as he did in the S&L reform effort, I think that we can really move this thing along.

It will take Presidential effort because there is a lot of inertia on this subject. There are lots of parties that are interested. I would hope that we can really accelerate the process.

It is my intention to do so. I know Chairman Gonzalez feels just as keenly about it. So I would like to see us really hit this issue head on early next year and move it to completion.

Let me ask you this. We sense from the testimony we have received that the Bank Insurance Fund is now at a low enough level and that there is enough stress and distress in the banking system that were just one or two major banks to fail, they could exhaust the reserve balances now in the fund.

Is that correct?

Mr. GLAUBER. I think, Mr. Chairman, there is no question that the Bank Insurance Fund is under stress. It has suffered substantial losses in 2 of the last 3 years and it is without question that it is operating at an historically whole level of revenues to insured deposits.

I believe, as Chairman Seidman has said, that under reasonably foreseeable scenarios, the Bank Insurance Fund will survive in good shape.

On the other hand, he has said and others have said that, if there were one or two major bank failures, that would run the risk of reducing the balance of the Bank Insurance Fund toward zero, or perhaps to zero.

What I cannot say to you today, of course, nor can I think anybody can say to you is that, it is impossible that we would have such failures.

What I can say is that I think it is most unlikely under any of the scenarios that we reasonably envision, but it is impossible for me to come before you and say: Never would this happen.

The CHAIRMAN. Let me ask you one other related thing because I don't want to lose track of this point, although my time is expiring here.

You mentioned three factors at work cutting the ground out from under a lot of the banks—problems in the real estate sector, Third World loans and highly leveraged transactions or bridge loans.

We are continuing to get erosion in all three of those areas. As the economy slows down, oil prices have gone way up. The real estate recession continues to spread, as nearly as we can tell, across the country.

We have got the tide running the wrong way in all three of these areas. And so it looks to me as if we will have continuing erosion of the capital and loan values at a lot of our banks.

Now, isn't that the trend line that we are on at the moment?

Mr. GLAUBER. I think we are certainly in the direction of erosion, as you put it. I think the important question is just how far that erosion will go.

You've got to remember, and I think all of us have to keep in mind, that with the banking industry, we are talking about an industry with substantial capital reserves.

The CHAIRMAN. Capital is unevenly distributed. That is the problem with the aggregate figure in your illustration. If one or two banks go, they could take down the rest of the insurance fund balance.

The problem is that you can have an average that looks good, but is composed of people with great strength and some with almost no strength.

Isn't that the problem?

Mr. GLAUBER. I will certainly accept that averages have that effect. But, nevertheless, again, I think it is important to remember that this industry, both on average and in almost all cases, has capital levels higher than any of the things that we experienced before with the thrift industry.

So, the fundamental question is:

How long and how deep will these trends be that are eroding the real estate industry? And the other kinds of lines that they hold.

I think that the industry can sustain, as it has in the past, some erosion. That, indeed, is the purpose of capital. That is the purpose of a fund balance.

The question is: How far will it go?

And as I say, at this time, for the foreseeable scenarios, it should not erode those protections to the taxpayer.

There are obviously Doom's Day scenarios, worst scenarios, that could erode it.

The CHAIRMAN. I will come back to that.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Mr. Glauber, there has been a lot of conversation about it, but there seems to be some confusion or misunderstanding as to whether the administration has or has not made a request to Congress on RTC funding for the upcoming fiscal year.

Could you tell us what Treasury's position is on that?

Mr. GLAUBER. I think, Senator Garn, our position is very simple.

We have made a request, and a very simple and very clear request, and that is that the RTC be supplied with additional funds before Congress leaves this year.

We have said that we cannot afford to let the RTC run out of funding, that it is likely to run out of funding for losses by the end of this calendar year.

And, therefore, we urge Congress to supply some funds to the RTC before it leaves. We have suggested that there are three alternative ways that Congress might choose to do this.

It might choose to do it in the form of a permanent indefinite appropriation. It might do it in the form of a small appropriation to carry the RTC through the spring, or into the spring of next year. Or, it might do it in terms of funds somewhere in between to carry it for a longer period.

Any of those are acceptable to us. We have made those statements very clear in a number of letters, both to members of this committee, and to members of the House of Representatives.

I made such a statement when I appeared before the House Banking Committee. The important point is that one of these alternatives be chosen by Congress.

We stand ready to act and help your committee in any way that you find useful. Indeed, at the request of the staff of this committee, we earlier this week supplied legislative language for all three of those alternatives.

And we stand ready to cooperate in any other way that you might see fit.

Senator GARN. Well, I would hope that we would not make the mistakes again of 1986, 1987 and 1988, when we did not supply sufficient money or authority.

And while it is fun to knock the 1988 deals—and there is no question that some of them need to be redone, and there is some wasted money there—as Chairman Seidman said the other day, the only choice they had is either those 1988 deals or no deals.

We ought to be smart enough not to put the regulatory agencies in that position again where they feel forced to get involved in deals that are not the most attractive and best for the taxpayers.

So, because of the confusion, I wanted you to answer that question, and emphasize the fact that no matter how painful it is, we do need to provide the necessary capital so that we are not getting back into those sorts of deals that we really precipitated in 1988. We also need to give you the working capital that is necessary to take these brain-dead institutions out of existence.

In determining the level of deposit insurance premiums to be charged to SAIF insured institutions, the Treasury bill says the Treasury's contribution to SAIF should not be considered.

Would you tell us why you are making the recommendation that they should not be considered?

Mr. GLAUBER. We think, both with the thrift industry, of course, as well as the commercial banking industry, that their funds should come first. That premiums should be set at a level which takes account of the ability of those industries to pay.

Obviously, in either industry, we should not set those premiums at a level so high that it is counterproductive. But, within the ability of those industries to pay and, in particular, in this case, within the ability of the thrift industry to pay, it should have premiums assessed on it which fully reflect its ability to pay.

That is why we say that the insurer should look to the industry to determine what is an appropriate level. And, of course, as FIRREA has mandated, behind that then stands the Treasury.

Senator GARN. As you know from my opening statement, I favor the flexibility that we are talking about in a number of these bills and insist that we do it before we leave.

But, on the other hand, I am concerned about the level of increase in deposit insurance premiums because I don't think anybody would disagree that one of the major problems that we have got to deal with is how to attract capital.

And if we don't attract capital to these institutions and make them valuable institutions that people want to purchase and inject capital into, then we just make the problem worse.

So, on the one hand, while we need to do this, aren't our goals contradictory between increases in premiums and trying to attract capital?

In essence, what I am saying, I guess, again, as I did to Mr. Seidman, we need to be careful.

And while I agree that flexibility is necessary, I am certainly going to vote to provide that, I would caution that there is a balance point there. And while rushing to increase the fund, we must not create more institutions that are on the chopping block.

Mr. GLAUBER. Senator Garn, I could not agree with you more completely. This is a very complicated issue that requires a balancing act. And as I said in my statement, it would be a mistake for the FDIC to raise premiums to a level that are counterproductive.

And I am sure Chairman Seidman wouldn't do it. The benefits of higher premiums are in one sense obvious. It is more money in the fund, a bigger buffer in that fund to absorb losses in the industry.

On the other hand, as you suggested, setting premiums too high I think will erode profits. And that can do, in my mind, three things.

One, as, again, you have suggested, it makes it difficult for the industry to attract capital.

Second, as profits are eroded, management in that industry might have a further incentive to take on riskier activities.

And, of course, third, as profits are eroded even further, more of those institutions could go over the edge.

So, in all of those senses, it is counterproductive. And as you have suggested, it really is a balancing act, one that the Chairman of the FDIC has to face. That is why we have proposed in our legislation that he be given the flexibility to make that judgment.

I think that the people on the front line who have access to the best data ought to be the people to make that judgment, bearing in mind these opposing considerations that you have suggested.

Senator GARN. Thank you.

Senator Shelby.

Senator SHELBY. I believe Senator Wirth is ahead of me.

Senator WIRTH. Thank you very much.

As you know, Mr. Glauber, we were very concerned in 1988. Mr. Gould and Mr. Wall came up and told us that they didn't need any more money, and then they went through the 1988 deals and justified those on the fact that, in part, they didn't get the money that they needed, although they didn't tell us that they needed money. And so they didn't need money. It was very circular.

So, I am pleased to hear you say that, in fact, more money is going to be needed.

Do you agree with Mr. Seidman, with the size of the number that he has testified to up here in the last week?

Mr. GLAUBER. I take it, we are now talking again about the thrift industry?

Senator WIRTH. We are talking again about the thrift industry.

Mr. GLAUBER. As I understand it, Chairman Seidman has said that they would need as much as $40 billion additional for losses and as much as $60 billion additional for working capital.

Senator WIRTH. And about $20 billion to redo the 1988 deals.

Mr. GLAUBER. About that amount. And I think what he said is that armed with that amount, that it might not be necessary to spend it because he could perhaps renegotiate.

Senator WIRTH. Do you agree with those numbers?

Mr. GLAUBER. The last figures, when the Secretary testified before this committee, he put forward loss numbers which ranged from $30 to $50 billion. That was before subtracting the amount still available from REFCORP. So that would, indeed, put it in the same range as Chairman Seidman's numbers.

Senator WIRTH. Do you agree with Chairman Seidman's numbers?

Mr. GLAUBER. On working capital, I must tell you that that is a harder figure to hit. It depends on the pace at which the FDIC will be able to sell or the RTC will be able to sell assets.

Chairman Seidman I think has on several occasions raised his estimate of the working capital needs. And I will tell you that that is something that we continue to study.

Our numbers had been slightly lower than that for working capital.

Senator WIRTH. How much money do you think Chairman Seidman needs? And this is a responsibility, Mr. Glauber, that the administration has, to come to the Congress to, one, tell us what you think the problem is. You are the people elected to do that job. One.

And, second, having identified the size and scope of the problem, to tell us how you believe we ought to meet that problem.

You are the executive branch. You propose. Now, we have in response to the letter that Chairman Riegle and others sent to you three options. We still do not have an answer from you either as to which option you prefer.

You say: Any of those options.

Now, I find it difficult dealing with—this is like squeezing on a sponge. How much money is involved? And, what option do you want us to pursue?

You have to give us an answer to those questions, I think.

Mr. GLAUBER. Senator Wirth, we have proposed—indeed, we are proposing—that money be appropriated before you leave. And we have given you three options. We have put specific numbers on——

Senator WIRTH. Which option do you prefer? Which one do you want?

Mr. GLAUBER. We believe the RTC can operate with any one of those three. We are willing to cooperate with you in any way necessary to bring whatever you choose to bring forward.

What is essential, Senator Wirth, is that the money be available to the RTC so that it does not run dry. What is really needed specifically is loss funds and we have said that, if you choose $20 billion of loss funds, that would be sufficient to let the RTC run through April.

Obviously, another alternative at the other end of the spectrum is the permanent and indefinite appropriation. Either of those will work for the RTC or anything in between.

What we need is money. And we very much hope that Congress will step up and provide that money before it goes.

Senator WIRTH. Essentially, what I'm hearing you saying is, one, you will not give us your best estimate as to what the specific figure is that is needed.

And, second, not having a specific figure for us, you will also not give us which option the administration prefers in terms of funding.

Mr. GLAUBER. I'm sorry. I may not have made myself clear, Senator Wirth.

Senator WIRTH. Maybe my question isn't clear. I've been asking the administration for some time and we still haven't gotten an answer.

Mr. GLAUBER. Let me try to make myself clear. We are delighted to give you a specific figure. $20 billion would be sufficient to carry the RTC through April.

Obviously, at the other end of the spectrum, there would be no specific figure because we would be talking about a permanent and indefinite appropriation.

In between, we can supply specific figures that will be sufficient for 1 year or 2 years. Ultimately, the question I think that faces Congress and this committee is how often it wants to see us come up here and talk about money.

Senator WIRTH. What would you prefer? How often do you want to come up here? What is your recommendation? You are the administration. What is your—you are responsible for administering the Government. What is your recommendation? What is your request to the Congress?

Mr. GLAUBER. I am prepared to come up here as often as asked. I enjoy myself at all times.

Senator WIRTH. I have never been in a situation—I have been up here now I guess for 16 years, and I don't think that I have been up here and had an administration come in and say:

Well, you all kind of decide what it is you want to do.

I mean, I think that there is an election that occurs, and there is only one office that gets elected to administer the Government. And I believe, Mr. Glauber, you have a responsibility to come up to us. The chairman has made that request on a number of occasions, and we still do not have an answer to that.

And I would hope that you all might be able to come back—we are running short of time. We do not want to be in this situation where the ambiguities of all of this at a very difficult time may cause the RTC to have to slow down. That is going to cost the taxpayer more money.

And I think we are just walking right into that.

I would think, Mr. Chairman, that, once again, we would want to renew the request as to what is sent, that the administration wants, and when. Which option is preferable?

Which one, in your opinion, may have the least damaging effect on the economy?

If you don't care, tell us which is the preferable option. I think that is a responsibility that you have. That request has been made over and over and over again.

Mr. GLAUBER. Senator Wirth, I don't think that there is an ambiguity on what the administration has said at all. We have said that $20 billion would be sufficient for the RTC to go through April. Another number would be sufficient for 1 year or 2 years. And, obviously, a permanent and indefinite appropriation would be sufficient for much longer.

There is no ambiguity. We need money. We need money before Congress goes out. Any of those will let the RTC run, which is the most important thing. We do not want the RTC to run dry. And we do not want Congress to allow it to run dry.

The CHAIRMAN. Would you yield at that, Senator Wirth?

Senator WIRTH. Yes.

The CHAIRMAN. This is a matter of concern to many of us here. And, as you know, I sent a letter to the Secretary that Senator Wirth has referred to, on September 13, asking for testimony on two subjects, one of the two being the one that you have testified on this morning.

The second, directly on this question. In other words:

What is the recommendation? What amount of money is needed and over what time period?

This question has taken on even a greater meaning now that we have the possibility of going back and renegotiating some of the 1988 deals save possibly $3–4 billion, according to the expert testimony.

I think the Secretary ought to decide, with help from you and others, precisely what is the best approach to take here, and let us know that.

I don't ask you to tell that to us today. You are not prepared to do so. But, it is important to pin that down and make a judgment. It ought to be a judgment that we make together. We need your best call on what you think is the proper amount, and over what time period.

Senator WIRTH. If I might, Mr. Chairman. Last week, as well. Chairman Seidman told us that $18–20 billion could be used next year to restructure some of the 1988 deals and thereby save the taxpayers some billions of dollars.

Could we also get a reply to where these funds should come from? And when we can expect a specific request from the RTC Oversight Board for those funds?

The CHAIRMAN. I think that is contained in my request.

Mr. GLAUBER. On that issue, Senator Wirth, the administration I think has been quite clear. We believe that Chairman Seidman should have the resources in order to renegotiate those deals. We have supported an indefinite appropriation to give him those resources.

And I think that would be an approach that we would hope would go forward. He has said, and we accept that, in order to effectively deal in those negotiations, he has to have the resources behind him.

Beyond that, as you know, the Oversight Board has asked Chairman Seidman to give it his recommendations on how to proceed with the 1988 deal renegotiations and the prioritization of how he would proceed.

And we are looking forward to receiving that back. But, for funding, we think he should have the funds he needs and an indefinite appropriation would be a way to do that.

The CHAIRMAN. If you would yield, I think we ought to go to Senator Bond here. But, if you want an indefinite appropriation, a blank check, I'm not sure what you mean by that.

In any event, we need a formal request. We need to respond to a specific amount of money that you are seeking, not only for working capital and case resolutions, but also to renegotiate 1988 deals.

The orderly way to do this is to have you folks decide how much of this you want to bite off. How much is for each of these activities, for the different component parts. And how it is to be done.

You get into the whole on-budget/off-budget question. We've been through that before. But, we cannot just wave a wand and get the money. We need to know how much, over what time period and for what purpose.

I don't say that to be contentious, but we can respond when we know precisely what it is that you want to try to do here.

Mr. GLAUBER. On the 1988 deals and in the spirit of trying to divide the problem, we have supported an indefinite appropriation. We have reported that to both Houses of Congress. And, indeed, the House has passed an indefinite appropriation.

On the others, as I say, we think the most important thing is that the money be provided.

Any of these alternatives work, and work fine.

And we are anxious to be as cooperative as possible with you, Mr. Chairman, in getting that money for the RTC.

The CHAIRMAN. If you would—and then I'm going to yield to Senator Bond—we would like the Secretary to give us a more specific blueprint. I think you understand what we are asking for.

Senator GARN. If the chairman would yield for a moment on this subject, because I asked the question about the confusion in this area. And sometimes I get a little bit weary with what appears to be assessing blame in both directions.

I don't say that in a partisan way. I have said publicly I am a little bit tired of both Republicans and Democrats.

I don't know how you can be much more specific. At least, it is obvious to me that you say that you've got to have at least $20 billion to last until April.

Now, that is pretty specific. It is also obvious to me, whether you will say it or not, that it would make more sense to not drag you up here every 6 months and say:

How much do you need for this 6 months?

I think Congress ought to be in a position to say:

OK, we are either going to give you the $20 billion before we leave so that will carry you into next April, so that when we come back with the new Congress, we can start the argument all over again, or we can give you a longer one—for 1 year or 2 years, or such sums as may be necessary, which is a better way to describe "indefinite."

So, at least this Senator feels that that is a pretty specific answer—$20 billion. And we damned well better at least do that. And if we have got any brains, we will do more than that, so that we don't keep playing the game over and over again.

This is too important a situation, to be dramatic. And after being around it for 15 years, it is time that we all got together.

And, please don't misunderstand. I am not pointing fingers at Senator Wirth. I am not talking about anyone in particular. I am just getting tired of the damned game-playing that goes on, on both sides of this, in the press.

And it is time we all got together and said:

This is too important a problem for the American taxpayer to play games with who said what and when.

We've got to have at least $20 billion. I would support more, so that we don't have to go through another hearing like this in April.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bond.

Senator BOND. Mr. Chairman, if I could turn the discussion back to the subject of the hearing today, I wanted to follow up on your discussion with Senator Garn and his question and your statement in your opening remarks to say that it would be counterproductive if the revenue from an increase in assessments were offset by losses from insolvencies caused by the increase.

And there has been slipping out under the door at Andrews Air Force Base a suggestion from somebody that one way to ease the deficit problem is to raise the insurance premiums to 27 cents per $100.

And given what we expect to come out of Andrews, if anything comes out, it would be written in a stone tablet.

So, I thought, perhaps before we get confronted with a sum mandated 27 cent increase, would you have some thoughts on what another 50 percent increase in the premiums might do to bring about the condition that you described in your remarks?

Mr. GLAUBER. Let me try to give you a little conceptual reasoning on the issue. First, let me say I don't think it would make sense to have the budget process drive our decision on what is the appropriate assessment level.

Senator BOND. I would agree strongly.

Mr. GLAUBER. Let me go on from there to say, again, as I suggested to Senator Garn, determining the appropriate level is a balancing act and one that obviously requires judgment. It is an art.

One way that we might think about this is to look at what burden additional assessments would impose upon the banking industry as compared to their profitability. And a place to start is to look at their profits in 1989, which were about 50 basis points. That is 50 cents per $100 of assets.

If you look at an increase to the current proposed level, which is 19.5 basis points, for the insurance premium, that, as compared to

1989, constitutes an increase of about 11 basis points, 11 cents per $100 of insured deposits, of domestic deposits.

And if you adjust that to its after-tax equivalent and restate it on the basis of assets rather than deposits, that is about 5 basis points, or 5 cents per $100 of assets. Five basis points, additional burden, contrasted with 50 basis points of profits seems to me like a reasonable additional burden.

As one goes beyond that, of course, the burden becomes larger. That is about 10 percent burden. If one went up to 27, it would be something closer to 20 percent additional burden.

That is a substantial portion of after-tax profits. Some of that could perhaps be passed through to depositors in the form of lower interest rates paid, or to borrowers in the form of higher lending interest rates charged. But, that would be limited.

So, I think, by looking at the increased burden of higher assessment rates in comparison to the profitability of the banking industry, you get some sense of what would be an appropriate trade-off. But, again, let me emphasize that really is a matter of art and a balancing act. And that is why we think the flexibility should be given to the FDIC where it can best be done.

Senator BOND. Not in the budget summit. You mentioned in your testimony, and the administration I think has previously taken the position that the FDIC should operate more like a private insurance business.

You also talked about the need to assess risk premiums. Some of us, frankly, with great confidence in our regulators, still have a minimum degree of confidence in the ability of any government activity to judge risk on a continuing basis.

Yesterday, Warren Buffet, who has gained a great deal of fame by his successful investments, came up with a proposal that appeared in the local paper, an op ed piece saying that:

There should be a percentage of private insurance covering a portion of the assets, and perhaps only for the larger banks. And that the private insurance market would thereby have to establish the rates, and make the risk determinations.

Do you think there is a role for private insurance in establishing risk-based premiums? And should we be examining that?

Mr. GLAUBER. I think the whole notion of private insurance, coinsurance, reinsurance, whatever form one talks about, is an intriguing idea. It is a complicated idea, and there are some conceptual problems with it. But it deserves a great deal of study and, indeed, we are studying it in our deposit insurance study.

The problems, if I can point them out, are, first, whether or not there is sufficient capacity in the system to provide private insurance. And that, of course, depends on the proposal. And, second, whether it would be there when you need it.

Many of us have had the experience, with automobile insurance, of having it cancelled after you have an accident. And there is some concern that the willingness of private insurers to step up to bat in rough economic times might be reduced.

So there are some problems with it, but they are by no means necessarily disabling. And I think it has to be considered very carefully.

Senator BOND. Mr. Chairman, I have a number of other questions I would like to have asked Mr. Glauber, but I understand, after the work that we have done on S&L's and the proposal that Senator Dodd and I had made with the cosponsorship of the Banking Committee, that a proposal was being debated on the floor which would address this question. And I think that I will go over and find out what our colleagues on the floor have to say about the S&L commission.

So I apologize for not being able to stay around.

The CHAIRMAN. Very good, Senator Bond.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Glauber, it has been testified here at this committee on several occasions that there was going to be at least 600–700 bank failures by 1995.

Could it be more than that? A lot more? Is that a conservative figure?

Mr. GLAUBER. I think it is very difficult to put a figure on it, Senator Shelby.

Senator SHELBY. I'm sure.

Mr. GLAUBER. The simple answer is we don't know. And that's why I think it is important both that we give the flexibility for assessment to the FDIC, that they get the level of the insurance fund up, and that we make the kinds of changes that we are discussing in the broader regulation and structure of the banking industry.

Senator SHELBY. If it is a situation that is unknown or maybe not totally predictable, wouldn't it be wise to prepare for that eventuality? In other words, a worst case scenario? Assuming that we are going into a recession, as a lot of economists predict, that a lot of these loans that are so-so today, that the reality is a lot worse than the numbers, I suppose.

Mr. GLAUBER. Senator Shelby, how serious the problems will be will depend on how prolonged any recession we have might be, how steep it would be. In preparing for a worst case scenario, as we have discussed earlier, some of those preparations could be utterly counterproductive.

By the act of, for example, raising premiums, to very high levels, we could force the outcome that we want to try to prevent. So, again——

Senator SHELBY. I agree with you that we should have a comprehensive approach to this. You know, you speak for the administration, as Senator Wirth reminded you a moment ago.

You didn't need reminding. I know that. But, at the same time, if you are speaking for the administration before the Banking Committee, we have got a situation that is of crisis proportions. I mean, that is undisputed as far as the fund is concerned, looking at the size of it, looking at the impending risk out there.

Where do we go from here? Do we play the same game that we played several years ago that has already been related on many occasions before this committee, that we are looking at the best side of it—the sunny side, rather than the gloomy side.

Mr. GLAUBER. Senator Shelby, just let me make a couple of points.

Senator SHELBY. Sure.

Mr. **Glauber**. First of all, the Bank Insurance Fund, as it functions, will inevitably rise and fall. That is the idea of an insurance fund, that you build it up and then you draw it down. You obviously want to make sure that you build it up far enough that you don't draw it down to zero.

Senator **Shelby**. Let me stop you just a second, and I will let you finish. That's true. It goes up and down. But, isn't it a fact that it is in the worst shape it has ever been in?

Mr. **Glauber**. It is now at a lower level relative to deposits than it has been.

Senator **Shelby**. And the risk that is pending out there.

Mr. **Glauber**. The risk obviously depends upon the outcome of the economy.

The other point I wanted to emphasize was that I think that we make a mistake if we say that the banking industry is the thrift industry all over again.

As I said in my statement, there are at least three major differences between these two industries. The banking industry has much more capital. It has been the subject of much more effective supervision, in the past, at least. And, finally, its assets are of a much higher quality.

It is prohibited from some of the riskiest kinds of assets that the thrift industry engaged in—junk bonds, those sorts of things.

So I think it is a mistake to see these two as history repeating itself. Having said that, let me say again:

Nobody—and certainly I'm not going to come up here and say to you "never" because we don't know. Under foreseeable outcomes, we don't believe that the bank fund is headed to zero. It is certainly true that, if we had one or several large bank failures, that would put the Fund under distress.

That is not viewed as a likely outcome by the regulators.

Senator **Shelby**. When you are dealing in mathematical probabilities, when there are as many banks—as you say, we all know that the thrift industry is not the banking industry. But, the banking industry is so large, so much larger, that the fund relative to the risk out there is mighty thin, isn't it?

Mr. **Glauber**. The fund is thinner than it has been. I think everyone who looks at it believes that it should be at a higher level relative to deposits. Indeed, that is the steps that Chairman Seidman is taking to build it to that. That is why we introduced this legislation, to provide him with more flexibility.

Senator **Shelby**. Let me ask you this.

It is my understanding that the regulators now have the authority to tell a bank, for example, that it is risky not to pay dividends, to hold it in.

Why have the regulators in your administration continued to let a lot of banks that are on the risky list—maybe not the problem list, but you see them down-grading. You see the real risk out there from Third World loans and nonperforming loans—continue to pay those dividends, because that has taken away from building up capital?

Mr. **Glauber**. Their decisions depend on the individual circumstances.

Senator **Shelby**. It is widespread with the bigger, riskier banks.

Mr. GLAUBER. I would point out to you that several of the regulators are not in our administration. I don't think that Chairman Seidman would say that he is in our administration. Nor would Chairman Greenspan. And with the Comptroller of the Currency, as you know, we don't deal in specific decisions. Their decisions clearly depend on their judgments in the individual circumstances.

One of the proposals that I discussed earlier is a proposal for a series of staged earlier intervention. We think that is a useful proposal and, indeed, it is part of Chairman Riegle's bill.

And we believe that ought to be part of the reforms that we take.

Senator SHELBY. But, we are in a crisis now, aren't we?

Mr. GLAUBER. Again, I think it would be a mistake to start waving the flag of crisis. What we are in is a situation with the fund under some stress. What happens from here on depends mainly on what happens to the economy.

Senator SHELBY. It sounds like some testimony we heard about the thrifts 2 or 3 years ago from that same table.

Mr. GLAUBER. Mr. Shelby——

Senator SHELBY. Not from you, but from some other people in the administration.

Mr. GLAUBER. I know that, but I think it is wrong to make that kind of comparison. I am not coming before you and saying this never can happen. What I am saying to you is that the fund is under stress. We don't believe that it is going to zero.

The Chairman of the FDIC has made that statement. We do believe that we should take prudent steps now to make sure that he has the assessment flexibility to raise the level of the fund's balance. And that we should take steps next year to structure the way this works.

Senator SHELBY. Next year could be a few months too late, couldn't it? Next year, we get into it in January or February and it is July-August before—September—before we move anything.

I think the chairman is right in introducing legislation now.

Mr. GLAUBER. I agree with that. And as the Chairman said, he thinks we should make this a top priority next year. I said, in answer to that, I believe we should as well.

Senator SHELBY. Shouldn't it be one of the administration's top priorities to save the American banking system?

Mr. GLAUBER. Again, Senator Shelby, I don't think it is useful to say that the American banking system is in the state that the thrift industry was in. It is a top priority.

Senator SHELBY. It is not in good shape when you talk about 600, 700, maybe 1,000 banks are going to fail in the next 4 years. And you're going to say that the banking system is not in bad shape.

Mr. GLAUBER. Senator Shelby, what I said is I think we need to take steps to make this industry more competitive, more profitable. And we are proposing those steps.

I don't think that in any sense we are turning our back on it. We believe that this is of fundamental importance. We should not do this in the waning hours of this Congress beyond, I think, the very useful step to give the FDIC more assessment flexibility.

We should take this issue up immediately next year and I assume that we are going to.

The CHAIRMAN. Thank you, Senator Shelby.

Senator Heinz?

Senator HEINZ. Mr. Chairman, thank you.

Mr. Glauber, from the standpoint of public policy do you have an opinion as to whether or not the FDIC should attempt to get the fund, the Bank Insurance Fund, up to at least the 1.25 percent of insured deposits by a date certain?

Mr. GLAUBER. Oh, I think I would hesitate to put a date certain, or to put down the number 1.25.

Senator HEINZ. Let us say a minimum of 1.25.

Mr. GLAUBER. Well, as you know, our legislation really gives the flexibility for setting that target to the FDIC. I think that the appropriate target will depend, among other things, on the decisions we make about the way we might change regulation of the banking industry, so that it does not make sense to have a legislated target.

That target is a moving target, if you will, and will depend on macroeconomic conditions, the state of the economy. It will depend on the regulatory choices and legislative choices that we make in the way we organize the banking industry.

Senator HEINZ. You recognize that there is some concern that, as has happened with the Airport Trust Fund, the Highway Trust Fund, as the Social Security Trust Fund is currently accounted for, that there is some worry that there will be pressure applied to the FDIC, to whomever replaces Mr. Seidman, to increase premiums really for budgetary purposes as opposed to simply for prudential purposes?

Mr. GLAUBER. No, I understand that. Indeed, Senator Bond and I exchanged views on this. I think that it would be a mistake to raise premiums to a level that is counterproductive, and it would certainly be a mistake to look upon the FDIC, the Fund, even though it is on-budget, as a source of revenues for the budget.

I think that the level of premiums that has to be set has to be one that makes sense for the fund. And as I said earlier, I think that is a balancing act.

Raising premiums too far clearly is going to be counterproductive. It is going to put pressures on profits that will reduce the flow of capital into the industry, encourage riskier assets, and ultimately put some of the marginal institutions over the edge.

Senator HEINZ. Perhaps you could make some sense out of the following formula. You have said that you do not have a goal in mind for the FDIC in terms of reaching the reserve ratio, a mandatory reserve ratio, whether it be 1.25 percent or higher.

Indeed, even if the FDIC made the maximum effort under current law, the GAO projected that the Bank Insurance Fund would not reach, in any event, the 1.25 percent by 1995, almost 5 years.

In a second study—that done by the Congressional Budget Office as reported in the American Banker just yesterday—they raised questions as to what would happen if you did reach that threshold by 1995, because they indicate that this would, if they raised premiums to 43 cents per $100 of deposits, which is apparently what they would have to do to get to the 1.25 by 1995, there would be a significant increase in bank failures because of that.

Now finally, just to make matters more difficult, in the FDIC testimony that we are going to receive on page 2 they state that for 1991 the 19.5 cent rate "should be adequate."

Now if that is true, and yet we have indications that raising it too high certainly as you suggest will be counterproductive, and yet the fund clearly has a very long way to go in order to get up to its minimum ratio which you suggest perhaps ought to be higher, if the FDIC is not planning to raise rates, why do they need the massive grant of flexibility that you advocate?

Mr. GLAUBER. I think what the FDIC plans to do now, and what it might do in the future, is clearly going to depend on the unfolding of events.

We think it should have the flexibility to act like a private insurer and raise rates when it believes it should without having to be bound by a series of, in some cases, fairly formidable constraints.

That is why we argue for flexibility, knowing as we do, and I am sure Chairman Seidman does, that raising the rates too far too quickly would be counterproductive.

Beyond that, I think your comments highlight the need for making changes in the way the banking industry functions so that its profitability can be enhanced, so that it can have a bigger buffer of both capital and insurance funds ahead of any taxpayer funds that ever would be needed.

So I think your comments simply call into very clear relief the point that Chairman Riegle made and others have made that we need to do more than simply this deposit insurance assessment flexibility, important as it is.

We need to go to the heart of the matter of how banks operate, how they are regulated, and what they can do, so that they can be more profitable, more competitive, and safer.

Senator HEINZ. Mr. Chairman, my time has expired. Thank you.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Graham from Florida.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Glauber, I would like to go back to the August agenda—or the October agenda of what should we be doing before recess.

On working capital you recommended in your statement that we give to the FDIC the additional capacity to borrow funds for working capital purposes?

Mr. GLAUBER. Yes. I noted that you mentioned that in your opening statement. As you know, in our bill we do propose that the FDIC be given access to the Federal Financing Bank for working capital.

We believe that the FDIC is a government agency and it ought to be able to have available to it working capital funds at the lowest possible cost—of course, making certain that they are only used for working capital and not for losses.

Senator GRAHAM. Would that borrowing be on-budget?

Mr. GLAUBER. That borrowing would be on-budget, as indeed all the FDIC's activities currently are on-budget. When the FDIC currently uses notes, those are on-budget.

The borrowing from the Federal Financing Bank would be on-budget. It would be the same budgetary treatment.

Senator GRAHAM. How much would you anticipate the savings to the FDIC would be by having access to the Federal Financing Bank as opposed to the current borrowing?

Mr. GLAUBER. The FDIC borrows from time to time with these notes at varying rates, but I am told up to 200 basis points over Treasury rates.

As you know, the FFB supplies funds at essentially Treasury rates.

Senator GRAHAM. No. 2 is adequate supervision. Are you satisfied with the level of supervision which will be available if the Congress adopts the administration's recommendations in terms of staffing patterns, level of compensation, the other factors that will influence the quality and extent of regulatory capacity?

Mr. GLAUBER. Well, I think the supervision and regulatory needs are going to depend greatly on the changes that we might make in the structure of the industry.

Senator GRAHAM. I am talking about, given the situation as it is today, are you satisfied that as of October 1, or when thereafter the new budget levels go into effect, that there will be sufficient supervisory capacity within the financial regulatory agencies to meet the shortfalls which have been described by previous witnesses?

Mr. GLAUBER. Well as you know, the budgets for the OCC and for the thrift regulator and for the Fed and the FDIC are obtained from the industry's funds. The industry pays for its regulation.

Where the administration intrudes in this of course, or where Congress intrudes, is in pay caps and pay restraints. As you know, those have been greatly eased so that the regulators can get the kind of talent that they feel they need.

Senator GRAHAM. I am asking you for an outside expert opinion as to whether, if the levels that have currently been recommended were to go into effect, that the Treasury would feel as if the level of supervision, quantitatively and qualitatively, was adequate.

Mr. GLAUBER. Again, I am not sure what recommendations and what congressional mandate you are talking about. The regulators set their staffing needs.

They set their assessment rates for examinations based on those views. I know that Chairman Ryan has been talking with the Treasury very recently about his budget and budgetary needs, as has Comptroller of the Currency Clark.

So the main function of Congress in this role is in these pay caps.

Senator GRAHAM. I have not been able to convey my question. I am asking for an external, expert opinion from the Treasury as to whether you believe, given all that you have said, that the recommendations of the regulators for quantity and quality of supervisory capacity, is sufficient.

I might say, we have asked the same question of GAO. GAO is going to give us in writing their independent assessment.

If you are not able to give an answer today, which would be perfectly understandable, I would also request a similar written supplementation.

Mr. GLAUBER. Well, Senator Graham, let me point out to you that most of the regulators in the banking industry are not subject to our oversight.

We do not oversee the Federal Reserve, although on some occasions some people have suggested we might want to, but we do not, nor do we want to.

We do not oversee the FDIC, as has been made clear on a number of occasions. So we are not in a position that we have made regular studies of the FDIC's budget or of the Federal Reserve's budget.

That is why I find your question difficult immediately to respond to.

Senator GRAHAM. In your comments in terms of what should be the standard for setting premiums, you said that you felt the standard ought to be the ability of the industry to pay premiums? Is that correct?

Mr. GLAUBER. Yes, sir.

Senator GRAHAM. I find that to be a curious standard.

Mr. GLAUBER. Excuse me. Could you repeat what you said? I apologize.

Senator GRAHAM. I note that in response to a question as to what should be the standard for the premiums to be set by FDIC, assuming it is given this greater flexibility, that your answer was that it should be the ability of the industry to pay the premiums.

Mr. GLAUBER. We said that that is one of the things that should be taken into account, as well as obviously the safety and soundness of the fund.

It has to be, as I have said on a number of occasions, a balancing act.

If the industry is unable to pay those premiums, if it imposes too great a burden on their profitability, it will be counterproductive.

They will not be able to attract capital. Some of the marginal ones would actually have to be resolved, and that would add a higher burden of cost.

Senator GRAHAM. Well, it seems to me that if you use the standard of the ability of the industry to pay, that you fall into one of two traps.

One is if that, in terms of actuarial adequacy, its inadequate, then you are essentially saying that we do not have an insurance fund, we have a subsidy.

Second, if on the other hand it is excessive, then we do not have an insurance fund we have a tax, raising the sorts of concerns that I think Senator Bond and others were raising.

Should not the standard for the premiums be a test of the marketplace, actuarial soundness, what is required?

Mr. GLAUBER. We suggested under our legislation that the standard be the one that is in current legislation.

One of the factors is the ability to pay, but it is only one of the factors.

The idea of the marketplace as a mechanism for assessing premiums is an intriguing one. That gets to the broader issue of coinsurance, which we have discussed some.

As I have said, I think coinsurance—and that is a mechanism for setting premium rates—is something that has to be studied.

We are looking very carefully at Senator Dixon's proposal, as well as others, and the one raised by Warren Buffet. So I do not in any sense want to dismiss that. I think it is well worth further consideration.

There are complications, as I suggested, to coinsurance, reinsurance, but it should not in any way be rejected.

Senator **Graham**. Mr. Chairman, my time has expired.

The **Chairman**. Thank you, Senator Graham.

We have now got substantive proposals on the table and you have accelerated your deposit insurance study. I applaud and appreciate that. I think we are moving pretty much in the same direction on the kind of major changes that are needed in the deposit insurance system, financial restructuring, and the larger questions of what the business charter ought to be for the banking industry.

This is not a simple matter. It has been around a long time. We have passed legislation but have not been able to get it through the Congress as a whole and on to the President's desk.

I would like to make a suggestion and lock into it. We need it for planning purposes, and the capital markets would be helped if they knew that we had serious intent and a game plan:

When we started on FIRREA early last year, the President invited a group of us, a bipartisan group from the House and the Senate to meet with him and discuss the problem and decide to go on an accelerated time schedule to get it done.

That set the tone and the stage, and we were able to move. We had a legislative package from the administration which you were instrumental in developing, and we put everything else aside here and we went on a forced march to get it done as quickly as we could.

And as complicated as the legislation was, we really got it done quite rapidly. By mid-year it was finished and the President was able to sign it, and we were able to start getting it implemented.

It was not perfect and it does need adjustments as we go down the track. But I would like to reach an understanding with the policy planners that you work with to do the same thing on this issue.

I think it is genuinely an urgent issue. It is not that we have got a full-blown crisis on our hands, but the banking system is critical to the vitality and stability of our whole economic structure.

We have applied about as much stress as we should prudently allow. It is time now to make the changes carefully and wisely and in a balanced fashion.

I would be prepared to suggest to my colleagues on this committee that we take that issue right off the bat next year, and put other things aside, and go through the hearing stage—we had 17 days of hearings on FIRREA here. We would do the same thing with respect to these issues.

It would be my intention to try to get this done. I have not talked with Chairman Gonzalez directly about that kind of a timetable, but I know he feels keenly about it, and I know he wants to move as well.

I see the Presidential election coming in 1992, and I know how Presidential politics come into play no matter which administration is in power. It starts to complicate the process the closer you get to 1992.

We have got a window in the first half of 1991. If we start fast, and if we start together and we come down through the early part of the first 6 months of the year together, we ought to be able to let everybody be heard, get all the good ideas on the table and sort them out. Obviously, we will have to do some cutting and fitting to have a package that has broad support, but I would like to see us get it done in the front end of 1991.

Now I do not know whether we have to be finished by September, or by August, or some other date, but I think our window for getting it done is in that period.

I would just add one other thought, too. I see Europe 1992 coming down the track, not to mention the rest of the world in this global economy.

We are seeing major inroads by international banks here in the United States and a tougher and tougher playing field for American banks abroad. The rest of the world is not going to wait for us.

We have had witnesses, very distinguished international witnesses, come in and testify before us this year. It is obvious to me that if the United States is not going to fall further behind in international competition, if we are going to restore integrity, safety, soundness and viability to the banking industdry, we have important work to do—work that is complex but cannot wait any longer.

I really would like to get it done in that time period, but if the President himself does not share this view and its priority-ranking, it will be very difficult to accomplish, because there are a lot of parties with different interests.

These are contentious issues, but if we work together, and with the House committee as well, on the understanding that we are going to give it expedited consideration, I think it can be done. And I think the country needs to have it done.

Mr. GLAUBER. Let me say that I agree with the broad thrust of your remarks that, while the banking system may not be in crisis, there is an urgency to get on with this and move quickly and we are committed to moving forward with determination to deal with it.

I would be happy to work with you to develop the timetable that would let us do that.

The CHAIRMAN. Well, I think you understand what I am saying. We are prepared to do our part. We did before. We will do again this time.

I am really asking that it be done. I have a sense of urgency. I know the President has a lot of things to have to weigh.

The situation in the Middle East is at the top of the list at the moment. There are some other important things, but the banking problems pose a real threat to us.

Things could get out of control. I do not want that to happen, but we need to act in an affirmative way. There can not be any more argument for delay.

The only way we can avoid delay is if you put this thing on a fast track and clear that track.

Mr. GLAUBER. Again let me just underline what I said earlier on, that we share the sense of urgency and the need to get on with this.

Indeed, that is why many months ago we committed to getting our study done early so that it could form the basis, together with other legislative proposals, for the dialog that has to begin right up front next year.

So we look forward to working out a timetable with you.

The **Chairman**. I am going to allow my colleagues a closing comment now, if they have one. Then we should go to the FDIC and the GAO witnesses that are here.

Senator **Garn**. Let me say, Mr. Chairman, and Mr. Glauber, that I agree with the chairman completely.

This process is not unknown. In 1988 this committee passed a broad restructuring bill on the Senate floor with only two negative votes, and that was because it was done in that type of atmosphere.

Chairman Riegle was there. Chairman Proxmire was the chairman at the time. We sat in his office endlessly and worked it out.

In the normal course of events, if we wait for an administration proposal, and then ours, and then weeks go by in between while people are studying back and forth, then you cannot meet that kind of a timetable.

So I wanted you to know that I agree with the Chairman that we ought to try to make it a joint effort, working in tandem with each other to try and produce it, because in a Presidential election year all bets are off, and it would be a tragedy if we do not have deposit insurance reforms and major restructuring of this industry before 1991 is over.

That is why I wanted to make certain that you understood that this was not just the chairman's feeling, but mine as well, that we need to have a joint effort of working together to shorten that time. Even then, it will be difficult to do it in that type of a timeframe, but I think we must.

Mr. **Glauber**. Well, Senator Garn, let me just say that I appreciate your comments. Furthermore, I think you know that this Treasury has enjoyed a very effective working relationship with the committee, and with the chairman in particular.

We certainly did on the thrift bill and, as the chairman pointed out, this committee was able to move that bill through the Senate in absolutely record time. We look forward to having the same kind of cooperative working relationship on this equally important legislation.

The **Chairman**. I want to make sure, too, that I have emphasized sufficiently the supervision and regulation aspects of this. They absolutely are key to the structure of what we can do.

Senator Graham, did you have a final comment you wanted to make?

Senator **Graham**. Thank you, Mr. Chairman.

I appreciate the fact that Mr. Glauber feels that on the RTC refunding that the administration has gone as far as it is prepared to go, at least at this time.

I would like to ask if Mr. Glauber would be willing to supplement his testimony today with some guidelines that he might recommend to the Congress as it attempts to select among the options that have been suggested.

For instance, would the guideline of on-budget financing that has been recommended for FDIC be recommended for RTC?

Would you recommend that where we were off-budget in financing in the 1989 FIRREA bill, that we rescind that and place all the remaining funds, whatever they may be, in an on-budget status?

That is illustrative of the policy recommendations which I think would be appropriate and helpful from the Treasury which is, in the final analysis, the public's agency of responsibility for oversight of the executive implementation of our Nation's financial matters.

Mr. GLAUBER. Well, Senator Graham, I would of course be happy to answer for the record any questions you might submit. As regards the ones you just asked, as you know currently RTC spending for working capital is on-budget. Any RTC spending that did not come from REFCORP for losses would be and is on-budget. And we have stated that we believe future spending for losses will come from the Treasury and be on-budget. So I think our position on those issues is quite clear.

The CHAIRMAN. Mr. Glauber, I would like to have an understanding with you that the minute your proposal is ready, I will convene this committee. I would like to have you unveil it here, whenever it is ready. Whether we are in session or out of session, we will summon the committee so that we can hear you the minute you are ready to go.

Mr. GLAUBER. I understand your interest and very much appreciate it. Let us work with you on a timetable to deal with the legislation.

The CHAIRMAN. Right. When you have got it done and are ready to let the world see it, I would very much like to have you walk right in this room and sit right down here again and present it to, get it started.

Mr. GLAUBER. Well, I appreciate the invitation and we look forward to working with you to try and work on a timetable.

The CHAIRMAN. Let me now excuse you as a witness and invite our other two witnesses up.

Thank you for your testimony.

Mr. John Bovenzi, who is the Deputy to the Chairman of the FDIC; and Mr. Donald Chapin, who is the Assistant Comptroller General of the U.S. General Accounting Office, ask both of you to come forward now.

As I call my other two witnesses to the table, as you know from the familiar bell system that a vote started just a few minutes ago. We will very shortly start the second bells on this vote.

Rather than have you begin and then be interrupted in 2 or 3 minutes, I will just recess the committee now for 15 minutes or so.

I realize you have been very patient in waiting, and we are very interested in having your testimony, but I will put the committee in recess for approximately 15 minutes and make this vote. When I do I will come back and we will resume.

The committee stands in recess.

[Recess.]

The CHAIRMAN. The committee will resume.

Let me invite all those in attendance to find a seat. We are prepared to resume. I want to say again that I appreciate the patience of our witnesses. It has been a long morning, and we had a vote on the floor and other items that had to be attended to over there that delayed my coming back immediately.

I think, Mr. Bovenzi, we will start with you. We would like to hear the view of the FDIC on this matter. We will make your full statement a part of the record in both your instances, so your summary remarks are what I really want to hear.

STATEMENT OF JOHN BOVENZI, DEPUTY TO THE CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION, WASHINGTON, DC.

Mr. BOVENZI. Thank you, Chairman Riegle. I will keep my remarks brief.

I am John Bovenzi, Deputy to Chairman Seidman. The Chairman extends his apologies to the committee for his absence, but I am pleased to be here to testify this morning, or this afternoon, on behalf of the FDIC concerning S. 3045.

S. 3045 would provide the FDIC with greater flexibility in adjusting the rates paid by banks for Federal deposit insurance.

The bill would change existing law by eliminating the current ceilings on annual increases in the insurance premiums.

It would also remove the existing overall cap on the assessment rate and would permit the FDIC to adjust the rate on a semiannual basis should the need arise.

The FDIC supports each of these provisions.

As you are aware, the Board of Directors of the FDIC has recently proposed an increase in the assessment rate for banks.

This increase, if adopted by the FDIC, would result in a bank assessment rate of 19.5 cents per $100 in deposits for calendar year 1991.

I should note that our Board will take up this action tomorrow morning in an open Board meeting, and we believe at this time that the rate increase is necessary and appropriate to enact.

We also believe, however, that it would be helpful if the FDIC were granted more flexibility as to the timing and amount of any future rate increases.

I would believe at some point in the not too distant future, given that additional flexibility, the Board would have to take a look at whether they wanted to make any further changes.

So, accordingly, we generally support the changes that would result from the enactment of S. 3045. Additional flexibility in assessing premiums will allow us to do our job better.

Flexibility also may facilitate bank discipline by allowing banks to immediately feel the effects of poor industry performance.

This may provide a strong incentive for more self-policing in the industry. However, the deposit insurance system cannot be fixed merely by charging higher premiums.

As you have so clearly pointed out, Chairman Riegle, we need to address the underlying factors as to why the premiums are so high.

There are problems in the deposit insurance system that need to be fixed, and there are problems in the banking industry itself which also need to be addressed.

In testimony yesterday before the House Banking Committee, Chairman Seidman identified supervision, capital, and risk management as three areas that must be at the forefront of our efforts to restore the deposit insurance system and the banking industry to health.

Chairman Riegle, we welcome your just-released proposal on deposit insurance reform, and intend to review it carefully.

Hopefully we will continue to move forward with legislation reforming the deposit insurance system, and the banking system in order to effectively complement the proposed legislation on deposit insurance assessments that is before us today.

We appreciate the foresight of the chairman and other members of this committee in introducing S. 3045.

If enacted, this legislation will give us a headstart in reforming the deposit insurance system.

There are, however, several additional considerations the committee might wish to explore in its deliberations on the bill.

First, S. 3045 is limited to assessments for the Bank Insurance Fund. We recommend that the bill be amended to grant the FDIC similar flexibility with respect to assessments for institutions that are members of the Savings Association Insurance Fund.

Under existing law, the FDIC has no authority to alter those rates until 1995, so we urge that S. 3045 be amended to retain parity in the FDIC's discretion to adjust the bank and savings association insurance rates.

Second, we recommend that the legislation remove provisions in existing law that mandate rebates of assessments.

We would prefer an approach similar to that contained in the Department of Treasury's proposal which provides the FDIC with the discretion to give rebates, taking into account the need to build up fund reserves to withstand future periods of unusual stress.

And as has been pointed out, from 1950 through 1983 FDIC income from assessments exceeded expenses and insurance losses and, as a result, the FDIC was required to rebate a portion of that surplus back to the banks in the form of a credit against future assessments.

These rebates totalled $6.7 billion over the 24-year period. The accumulated interest foregone equalled $24.9 billion.

Thus, had these rebates not taken place, the Bank Insurance Fund today would have an additional $31.6 billion and would have stood at approximately $45 billion at the end of 1989.

The third point I would like to make is that the committee might wish to consider including minimum assessment rates for the two funds at levels similar to those prescribed as minimum annual assessment rates under existing law.

One potential benefit of a statutory minimum is that it provides guidance as to the minimum rates Congress considers to be appropriate. Another benefit is that it establishes a base rate that would be applicable in the absence of any explicit FDIC action.

So in summary, the FDIC believes that the increased flexibility granted by S. 3045 is a positive step. We urge that it be extended to cover the Savings Association Insurance Fund assessments, as well as banking industry assessments; that it provide greater discretion with regard to rebates; and that a minimum assessment rate be included.

That concludes my oral statement, and I will be pleased to answer any questions.

[The complete prepared statement of John F. Bovenzi follows:]

TESTIMONY OF

JOHN F. BOVENZI
DEPUTY TO THE CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

ON

S. 3045

BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

SEPTEMBER 26, 1990
ROOM 538 DIRKSEN SENATE OFFICE BUILDING

Good morning, Chairman Riegle, Senator Garn and members of the Committee. I am John Bovenzi, Deputy to Chairman Seidman. The Chairman extends apologies to the Committee for his absence, but I am pleased to testify this morning on behalf of the Federal Deposit Insurance Corporation concerning S. 3045.

S. 3045 would provide the FDIC with greater flexibility in adjusting the rates paid by banks for federal deposit insurance. The bill would change existing law by eliminating the current ceilings on annual increases in the insurance premiums, or assessments, paid by banks to the FDIC. It would also remove the existing overall cap on the assessment rate, and would permit the FDIC to adjust the rate on a semiannual basis should the need arise. The FDIC supports each of these provisions.

Under existing law, the assessment rates to be applied in any particular year are set by statute, with a narrow grant of authority to the FDIC to impose limited increases above the statutory rate. For the Bank Insurance Fund, or BIF, the statutory rate for calendar year 1991 and thereafter is 15 cents per $100 in deposits. For the Saving Association Insurance Fund, or SAIF, the statutory rate increases from 20.8 cents to 23 cents for 1991 through 1993, then decreases to 18 cents in 1994. The Savings Association Insurance Fund rate decreases again in 1998, to the statutory Bank Insurance Fund rate of 15 cents.

Existing law also establishes a reserve ratio -- or a ratio of insurance Fund balances to insured deposits -- of 1.25 percent, with provision for increase by the FDIC to 1.50 percent. If the FDIC increases the reserve ratio above 1.25 percent, investment income on the assessments attributable to the increase will be redistributed to Fund member institutions. If the FDIC subsequently determines that BIF or SAIF exceeds the appropriate designated reserve ratio, the excess funds are to be credited to the member institutions.

As you are aware, the Board of Directors of the FDIC has recently proposed an increase in the assessment rate for banks. This increase, if adopted by the FDIC, would result in a bank assessment rate of 19.5 cents per $100 in deposits for calendar year 1991. At this time, we believe that this rate should be adequate. We also believe, however, that it would be helpful if the FDIC were granted more flexibility as to the timing and amount of any future rate increases.

Accordingly, we generally support the changes that would result from enactment of S. 3045. Additional flexibility in assessing premiums will allow us to do our job better. Flexibility also may facilitate bank discipline by allowing banks to immediately feel the effects of poor industry performance -- this may provide a strong incentive for more self-policing in the industry.

However, the deposit insurance system cannot be fixed merely by charging higher premiums. We need to address the underlying factors as to why the premiums are to be so high. There are problems in the deposit insurance system that need to be addressed and there are problems in the banking industry itself, which also need to be addressed.

In testimony yesterday before the House Banking Committee, Chairman Seidman identified supervision, capital and risk management as three areas that must be at the forefront of our efforts to restore the deposit insurance system and the banking industry to health. Chairman Riegle, we welcome your just released proposal on deposit insurance reform and intend to review it carefully. Hopefully, we will continue to move forward with legislation reforming the deposit insurance system and the banking system in order to effectively complement the proposed legislation on deposit insurance assessments that is before us today.

We appreciate the foresight of the Chairman and other members of this Committee in introducing S. 3045. If enacted, this legislation will give us a head start in reforming the deposit insurance system. There are, however, several additional considerations the Committee might wish to explore in its deliberations on the bill.

First, S. 3045 is limited to assessments for the Bank Insurance Fund. We recommend that the bill be amended to grant the FDIC similar flexibility with respect to assessments for institutions which are members of the Savings Association Insurance Fund. Under existing law, the FDIC has no authority to alter SAIF rates until 1995. We urge that S. 3045 be amended to retain parity in the FDIC's discretion to adjust BIF and SAIF rates.

Second, we recommend that the legislation remove provisions in existing law that mandate rebates of assessments. We would prefer an approach similar to that contained in the Department of Treasury's proposal which provides the FDIC with the discretion to give rebates, taking into account the need to build up fund reserves to withstand future periods of unusual stress. From 1950 through 1983 FDIC income from assessments exceeded expenses and insurance losses. As a result, the FDIC was required to rebate a portion of that surplus back to the banks in the form of a credit against future assessments. These rebates totalled $6.7 billion over the 24-year period. The accumulated interest foregone equalled $24.9 billion. Thus, had these rebates not taken place, the Bank Insurance Fund today would have an additional $31.6 billion, and would have stood at approximately $45 billion at the end of 1989.

Third, the Committee might wish to consider including minimum assessment rates for the two Funds, at levels similar to those prescribed as minimum annual assessment rates under existing law. One potential benefit of a statutory minimum is that it provides guidance as to the minimum rates Congress considers to be appropriate. Another benefit is that it establishes a base rate that would be applicable in the absence of FDIC action.

In summary, the FDIC believes that the increased flexibility granted by S. 3045 is a positive step. We urge that it be extended to cover SAIF assessments as well as BIF assessments, that it provide greater discretion with regard to rebates, and that a minimum assessment rate be included.

I will be pleased to answer any questions the panel may have.

The Chairman. Very good. Thank you for your comments.

Mr. Chapin?

STATEMENT OF DONALD H. CHAPIN, ASSISTANT COMPTROLLER GENERAL, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. Chapin. Mr. Chairman, I will summarize my statement hopefully within 5 minutes.

Immediate action is needed to shore up the Bank Insurance Fund and to institute certain other reforms.

We support the committee's proposal to allow FDIC flexibility in setting assessment rates.

We have suggested that the committee's proposal could be further strengthened by some enhancements:

Eliminating the maximum reserve ratio, and setting a target date for achievement of the minimum ratio with increases in rates to consider economic conditions of the banks would enhance the bill.

The administration's proposal presented this morning, as we understand it, also eliminates the maximum reserve ratio and has certain other enhancements which we would support.

We take no exception to the FDIC proposals to broaden coverage as presented this morning, as well.

There are a number of other bills being introduced and considered by Congress, including the Riegle bill introduced Tuesday which would deal with deposit insurance reform and other longer-term problems.

The bill you introduced Tuesday demonstrates a positive and timely commitment to deal with critically needed reforms.

These and other reforms will need to be carefully considered.

FIRREA, as you know, requires that these longer term issues be addressed early next year.

We are not aware, however, of any action being taken or active consideration being given to certain short-term problems which afflict the banking industry other than the bill being considered today.

We believe that the resolution of these short-term problems is critical to stabilizing the Bank Insurance Fund.

Unless some of these problems that we have pointed out are dealt with quickly, the fund will continue to take unnecessary losses.

As you requested on September 11, we have written to this committee as well as to the House Banking Committee urging the Congress to encourage certain administrative actions which are set forth in our testimony and documented and supported in our audit of the Bank Insurance Fund.

I refer to such things as requiring full scope, on-site examinations of troubled and major banks; quarterly reviews of the large banks; and dealing with weak accounting principles that allow losses to go unreported until it is too late to save the banks.

We have also sent to both committees proposed legislation which would make internal control, auditing, and management reforms in the private sector.

Additional action is necessary in the short term to protect the Government's interest.

Our work with the S&L debacle and our current work in the banking crisis has shown that the reforms we have recommended are needed to strengthen financial institutions and minimize losses to the insurance funds.

Time after time, S&L's and banks have failed because they have not maintained good internal controls.

Violations of banking laws and regulations, unchecked by the auditors, have contributed to many of these failures.

Effective audit committees have not been in place to stop the management abuses we read so much about in the news these days.

We realize that these matters are not on your agenda today, and we are working with your staff on these issues.

We urge the committee to consider our legislative proposals in the immediate future and try to enact appropriate legislation dealing with internal control, with auditing, with reporting, and the management reasons for the S&L and bank failures.

Mr. Chairman, the Comptroller General feels strongly that the short term actions I have suggested and covered in my prepared testimony submitted to you are important matters to be dealt with before the end of the calendar year.

If you cannot get to our legislative recommendations this year, we believe that it is absolutely critical in our view that these actions be taken up first in 1991.

To advance the discussion of this important subject, we would request that you give consideration to adding our legislative recommendations to your deposit reform bill so that it can be considered and thought about in the time period until that bill comes up.

Thank you, sir.

That concludes my summary.

[The complete prepared statement of Donald H. Chapin follows:]

United States General Accounting Office

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Immediate Measures That Can Be Taken to Strengthen the Bank Insurance Fund

Statement of
Donald H. Chapin
Assistant Comptroller General
Accounting and Financial Management Division

Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

GAO/T-AFMD-90-33

GAO Form 160 (12/87)

IMMEDIATE MEASURES THAT CAN BE TAKEN TO STRENGTHEN THE BANK INSURANCE FUND

Statement of Donald H. Chapin
Assistant Comptroller General
Accounting and Financial Management Division

Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

September 26, 1990

The Bank Insurance Fund is too thinly capitalized to withstand the level of bank failures that would occur in the event of a recession. Projections show the ratio of the Fund's balance to insured deposits declining to as low as .58 percent by year-end 1990. Immediate action is needed to shore up the insurance fund and institute financial institution reforms to prevent a crisis in the nation's banking system.

We support the Committee's proposal to allow FDIC flexibility in setting assessment rates that will enable the Fund to maintain the minimum designated reserve ratio to insured deposits. We believe the proposal could be further strengthened by specifying a target date in which the Fund balance should achieve the designated minimum reserve ratio, providing that consideration be given to the economic conditions affecting the financial health of the banking industry in setting assessment rate increases, and removing the ceiling on the reserve ratio set at 1.50 by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

In addition to lifting the restrictions on increasing assessment rates currently imposed by FIRREA, there are a number of other short-term measures that can be implemented through administrative actions before Congress recesses that will help to strengthen the Fund. These measures are outlined in detail in a September 13, 1990, letter to this Committee from the Comptroller General and include:

-- the Department of the Treasury including in its deposit insurance reform study a determination of a Fund reserve ratio to protect taxpayers in a recession;

-- the bank regulators requiring annual on-site, full scope examinations of large banks and problem banks as well as reviews of quarterly reports for large banks by independent public accountants;

-- ensuring that FDIC has sufficient cash resources to take necessary regulatory actions and that assets acquired from failed banks are realistically valued to avoid unexpected losses to the Fund; and

-- strongly encouraging the accounting profession to clarify accounting rules regarding loss recognition and determining the loss amounts for nonperforming loans and real estate acquired through foreclosure.

Another issue which Congress should address before the end of this year is the need for legislation to enact comprehensive internal control, auditing, reporting and management reforms for financial institutions. Our past and ongoing work has shown that these reforms are needed to strengthen financial institutions, and minimize losses to the insurance funds. Specifically, legislation is needed that requires that:

-- financial institutions prepare annual financial statements in accordance with generally accepted accounting principles;

-- financial institutions establish adequate internal controls and annually assess and report on the adequacy of the institution's internal controls;

-- independent public accountants annually audit the institution's financial statements, and examine and report on the institution's assessment of its internal controls;

-- audits of financial institutions be performed only by independent public accountants who have received an adequate peer review;

-- independent public accountants identify all significant related party transactions and review their financial substance;

-- independent public accountants use specific procedures to determine compliance with applicable laws and regulations including those relating to safety and soundness;

-- independent public accountants review risks and uncertainties and evaluate the institution's ability to continue in business over the next year;

-- independent public accountants pursue indications of illegality by the institution, inform the management and directors of the institution if the accountant determines that an illegality likely occurred, and if the institution does not take corrective action on a substantial illegality report to FDIC, resign from the audit, or both; and

- institutions establish truly independent audit committees that include lawyers whose duties include reviewing the basis for the reports issued by an institution's management and accountants.

We believe that these measures, if promptly addressed, will aid in reducing the risk of a major crisis in the banking industry. Our goal is to ensure a sound system of deposit insurance that continues to maintain public confidence and can withstand adverse economic conditions without costing the nation's taxpayers billions of dollars.

Mr. Chairman and Members of the Committee:

We are pleased to be here today to provide comments on your proposal to allow the Federal Deposit Insurance Corporation (FDIC) flexibility in setting deposit insurance premiums. In recent testimony before this Committee,[1] we stressed the need for immediate actions to protect the Bank Insurance Fund until long-term deposit insurance reforms can be considered as required by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). At that time, the Committee asked us to provide a list of actions the Congress and the administration could immediately implement to protect the nation's system of deposit insurance and, ultimately, the taxpayers. We provided this list in a letter to the Committee which contained 11 recommendations and draft legislation. I ask that this letter, dated September 13, 1990, and a follow-up letter, dated September 14, 1990, be introduced into the record at this time. I will discuss the specific recommendations later in my statement.

We are encouraged by the Committee's recognition that action must be taken quickly to strengthen the Bank Insurance Fund. The Committee's proposed amendment to the Federal Deposit Insurance Act maintains the designated reserve ratio but eliminates the restrictive caps on assessment rate increases that FDIC may charge member banks for deposit insurance coverage. It also allows the

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[1] Additional Reserves and Reforms are Needed to Strengthen the Bank Insurance Fund (GAO/T-AFMD-90-28, September 11, 1990).

FDIC Board of Directors to determine the appropriate assessment rate to be charged. This is an important first step toward strengthening the Fund and is similar to our proposed amendment which we offered for consideration as the first of our 11 recommendations.

Both our projections of the Bank Insurance Fund balance and FDIC's show that with the restrictions currently imposed by FIRREA on setting assessment rates the Fund will not achieve the FIRREA designated minimum reserve ratio of 1.25 percent by 1995. As we previously testified before this Committee, and as we discuss in our recently issued report,[2] the Fund is too thinly capitalized for the exposures it currently faces. The Fund ended 1989 with its second consecutive loss, $852 million, which reduced the Fund's ratio to insured deposits to .7 percent, the lowest this ratio has ever been. FDIC now expects the Fund to lose as much as $2 billion in 1990, and our own projections show the Fund's ratio to insured deposits decreasing to as low as .58 percent by year-end 1990. The allowable assessment increases designated by FIRREA will be insufficient to protect the Fund in the event of a recession that results in significant bank failures. The Fund's reserves need to be increased to ensure that a recession will not deplete the Fund and result in costs to the taxpayer.

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[2] Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, September 11, 1990).

Although we support the Committee's proposal to allow FDIC flexibility in setting assessments to maintain the designated reserve ratio, we believe the proposal could be further strengthened by (1) specifying in the amendment a target date by which the Fund balance should achieve the designated minimum reserve ratio to insured deposits, (2) providing that in setting assessment rate increases, consideration be given to the economic conditions affecting the financial health of the banking industry, and (3) removing the ceiling on the reserve ratio set by FIRREA at 1.50.

While your amendment is a necessary first step, the other steps we have recommended are also vital. We believe that this first step should be implemented in conjunction with other measures discussed in detail in our letters to this Committee. These short-term measures can be taken in this session of Congress to protect the Fund and can largely be implemented administratively. Thus, the Committee should request that:

-- the Department of the Treasury include in its study of deposit insurance reform (1) an assessment of the reasonableness of the minimum and maximum reserve ratios designated by FIRREA in light of the banking industry's present condition and the Fund's exposure, (2) a reserve ratio target that would protect taxpayers in a recession, and (3) means, in addition to premium assessments, such as increased capital levels in banks, that would reduce the Fund's potential liabilities;

- -- the Chairman, Federal Deposit Insurance Corporation; the Chairman, Federal Reserve Board; and the Comptroller of the Currency immediately implement a policy to conduct annual on-site, full scope examinations of large banks and problem banks and obtain such staffing levels as are needed to perform these examinations;

- -- the bank regulatory agencies immediately require that large banks whose failure would cause a significant cost to the Fund have their quarterly call reports reviewed by an independent public accountant;

- -- the Chairman, Federal Deposit Insurance Corporation, (1) closely monitor the Fund's cash resources and promptly advise the Committee of any projected cash shortages so that the Congress can consider other means to ensure that necessary regulatory action is not delayed because of a lack of cash resources, and (2) immediately revise FDIC's guidelines for recorded values of assets to include a critical review of the appraisers' underlying assumptions in valuing assets acquired from failed banks and adjust recorded values to reflect these assets' realistic values in light of their historical experience and current conditions;

-- the Committee itself reaffirm, through a Senate resolution or other means, its intent that bank regulators use the regulatory authority conferred in FIRREA and elsewhere to minimize losses to the Bank Insurance Fund and to ensure the stability of the banking system, specifying its expectation that the regulators act promptly to enforce safe and sound banking operations and protect the Fund;

-- the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) together take prompt action to clarify the authoritative accounting rules regarding loss recognition and determination of loss amounts for nonperforming loans and other real estate owned that was acquired through foreclosure. This clarifying guidance should be made available to the banking industry in time for use in the 1990 reporting cycle;

-- the Securities and Exchange Commission (SEC) monitor the progress of the FASB and AICPA in developing guidance on loss recognition and determination of loss amounts for nonperforming loans and other real estate owned that was acquired through foreclosure, and issue guidance on interpreting these accounting rules if the accounting authorities are unable to meet the December timetable. All banking institutions, including those reporting to other regulatory bodies, should then be required to follow this guidance.

The measures outlined above can, and should, be implemented before the Congress recesses. Another issue which Congress should address before the end of this calendar year is the need to enact legislation that requires comprehensive internal control, auditing, reporting, and management reforms for financial institutions. Such reforms are needed to help prevent these institutions from getting into trouble, to provide regulators with an early warning when institutions begin to get into trouble, and to protect against the kind of fraud and other illegal acts that occurred in the savings and loan industry. The government needs to take responsibility for these areas that up until now have been largely left to the private sector to better protect its interests as insurer of deposits. The government, because of its insurance commitments, has at least as much right to protection as shareholders of financial institutions.

Our past and ongoing work has disclosed serious internal control weaknesses in financial institutions. Before enactment of FIRREA, we reported that serious internal control weaknesses cited by federal regulators contributed significantly to the failure of virtually all of the 184 banks which failed in 1987.[3] We also reported that regulators' examination reports and related data showed numerous and sometimes blatant violations of laws and regulations at 26 failed savings and loans that we reviewed to determine the cause of their failure.[4] At that time, we recommended that FIRREA include requirements for insured institutions to undergo annual financial audits and to issue management reports on the effectiveness of their internal controls and on their compliance with safety and soundness laws and regulations. To provide assurance on the validity of the management reports, we also recommended that, as part of the annual audit, auditors be required to review and report on management's assertions contained in its reports. Unfortunately, these recommendations were not included by the Congress in FIRREA.

Our ongoing work has disclosed that weak internal controls continue to be a serious problem in financial institutions and continue to contribute significantly to failures. Our review of examination reports for 39 of the largest banks of the 406 banks that failed in 1988 or 1989 disclosed that many of the institutions had serious internal control weaknesses.

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[3] Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

[4] Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

Management and the boards of directors of financial institutions have a responsibility to operate their institutions in a safe and sound manner. Safety and soundness relates not only to overseeing the day-to-day operations of the institution, but also to establishing and maintaining an effective internal control structure. Such a structure increases an institution's ability to protect its assets and deal with economic adversity in an effective manner. The internal control structure should ensure that (1) transactions are executed and access to assets is permitted only in accordance with management's authorization, (2) transactions are recorded to permit preparation of financial statements in conformity with sound accounting principles and to maintain accountability for assets, and (3) the institution complies with all applicable laws and regulations, especially those relating to safety and soundness.

The accounting profession also plays a significant role in ensuring corporate accountability. Unfortunately, not all banks receive an annual audit by independent public accountants. Additionally, there are deficiencies in the audits of some financial institution which are audited by independent public accountants. In recent years, the accounting profession has acted to strengthen some of the auditing procedures vital to determining the true condition of financial institutions. In our view, however, the guidance provided by the profession has not been sufficiently specific and substantive to ensure that audits are conducted in an effective manner. Most importantly, the profession has not agreed to include a review of compliance with safety and soundness laws and regulations as part of a financial institutions annual audit.

The problems disclosed by internal control reviews and audits do not always receive the attention they should by managers of financial institutions who, particularly in times of stress, may attempt to cover up problems or protect their own actions from scrutiny. Additional measures to shore up the corporate governance process need to be taken. Communication between the independent public accountant and regulators needs to be improved, with the auditor reporting violations of laws and regulations to the regulators on a timely basis, and the regulators providing information on the condition of the institution to the auditor. The auditor's work also needs to be subject to strict peer review. Truly independent audit committees that include lawyers must be established to ensure that both managers of financial institutions and auditors perform their roles and duties in a responsible manner. We believe that all the major financial institutions players--managers, directors, auditors, and regulators--must work together and work effectively to protect the taxpayer.

We are convinced that legislation dealing with the internal control, auditing, reporting, and management problems we have mentioned is critical to reducing the risk of loss to the insurance funds. Therefore, as stated in our recent letters to the Committee, we recommend that legislation be enacted requiring that:

- -- financial institutions prepare annual financial statements in accordance with generally accepted accounting principles;

- -- financial institutions establish adequate internal controls and annually assess and report on whether such controls provide reasonable assurance that (1) transactions are executed and access to assets is permitted only in accordance with management's authorization, (2) transactions are recorded to permit preparation of financial statements in conformity with sound accounting principles and to maintain accountability for assets, and (3) the institution complies with applicable laws and regulations including those related to safety and soundness;

- -- independent public accountants annually audit the institution's financial statements and examine and report on the institution's assessment of its internal controls;

- -- audits of financial institutions be performed only by independent public accountants who have received an adequate peer review;

-- independent public accountants identify all significant related party transactions and review their financial substance;

-- independent public accountants use specific procedures to determine compliance with applicable laws and regulations, including those relating to safety and soundness;

-- independent public accountants review risks and uncertainties and evaluate the institution's ability to continue in business over the next year;

-- independent public accountants pursue indications of illegality by the institution, inform the management and directors of the institution if it is determined that an illegality has likely occurred and, if the institution does not take corrective action on a substantial illegality, report to FDIC, resign from the audit, or both; and

-- institutions establish truly independent audit committees that include lawyers whose duties include reviewing the basis for the reports issued by an institution's management and accountants.

Our initial letter dated September 13, 1990, included proposed legislation for the Committee to consider which would implement our proposed recommendations by amending the Securities Exchange Act of 1934. This proposal was offered because of consideration being given in the House of Representatives to a proposal that would repeal the 1934 Act's section 12(i) exemption for financial institutions and address some of the reforms needed. Our proposed legislation would have strengthened the House bill. Our follow-up letter included proposed legislation with respect to financial institutions by amending the Federal Deposit Insurance Act. We are satisfied that this legislation contains the measures necessary to reduce the risk of loss to the Bank Insurance Fund. We urge that this legislation be enacted before the end of the calendar year so that its provisions can be fully effective in 1991.

CONCLUSIONS

We believe that the measures we have outlined today, if promptly addressed, will assist in reducing the risk of a major crisis in the banking industry. Our goal is to ensure a sound system of deposit insurance that continues to maintain public confidence and can withstand adverse economic conditions without costing the nation's taxpayers billions of dollars. The amendment you have proposed to allow FDIC more flexibility in setting premiums is a critical first step to protect the Bank Insurance Fund.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or other members of the Committee may have.

The CHAIRMAN. Thank you, Mr. Chapin.

We ask you, when we get the administration's proposal, to look specifically at the examination and supervision sections. I understand that you have undertaken to do that and to give us a timely, prompt response. Is that right?

Mr. CHAPIN. We will do so, Mr. Chairman.

We have underway, and are planning a more indepth review of the supervision process, but we know a lot about the subject now. We will know more later, and we will be delighted to testify on a timely basis.

The CHAIRMAN. Very good. It is going to be important that we have that.

I would like each of you to give me a brief assessment of where the Bank Insurance Fund stands at the moment, not at the end of last year but where it is today your assessment of the need for this legislation.

Why do I not start with you, Mr. Chapin.

Mr. CHAPIN. We believe the fund at the present time is paper-thin, in view of the risk facing the banking industry. As has been said before this morning, we believe that one or more major failures of the major money center banks could reduce the fund to virtually zero.

We believe further that with an extended recession, which is possible, that the fund could be exhausted. We believe that this is a critical situation that needs to be faced. We believe your bill does so.

By freeing the FDIC to deal with rate increases, it is possible to rebuild much of this fund over the next few years. We recognize that the banking industry is concerned about insurance rates, but would remind the committee that at 19.5 cents it is still only 1 percent of a bank's expenses. It maybe overblown in some respects by some of those that fear its consequences on the health of the banking industry.

We believe that your bill is quite appropriate; that we need to go ahead with it, and we would be delighted to have the FDIC Board empowered to raise rates, and we think it should be done.

The CHAIRMAN. Thank you.

Mr. BOVENZI. I would agree that the bill is important and necessary. The FDIC fund, as we have said before, is clearly under stress. The ratio of the fund to insured deposits is at its lowest level ever, and the prospect is that it is going to decline further before this year is out. So the fund is weak.

We would like to build it up as quickly as possible. We are doing that to the extent we can under existing law. The bill you are proposing will give us additional flexibility so that we can look at it further to see what, if any, additional measures may need to be done as time goes on.

There are risks in the system and conditions change quickly. At the moment we feel that the fund is adequate for what we foresee, but there are certainly risks out there and we need the flexibility to be able to adjust to changes in the environment as they occur. This proposed legislation would allow us to do that.

The CHAIRMAN. Assuming this legislation is passed, are you likely to use any of these provisions say over the next 6 months?

Mr. BOVENZI. It is my belief we would take that up before the end of the year. We have an obligation under the current law to decide by September 30 what, if any, increases over what is set in law would go into place. So we are having a Board meeting tomorrow morning to address that, as I mentioned before.

But then if this bill is passed and we have that extra flexibility, I would believe we would have to look at the issue again before the year was out and see what the conditions in the industry were and evaluate it at that point.

The CHAIRMAN. Now if the Treasury's language on the SAIF premiums were to be added to the bill, how would the FDIC go about determining an appropriate rate for SAIF premiums over the next 2 or 3 years?

Mr. BOVENZI. I think right now the SAIF premiums are not being used to fund the Savings Association Insurance Fund, but within a couple of years they will be, and there will be questions then as to what will be an appropriate rate to be paid.

There will be important competitive issues that will come up. If we have the flexibility to adjust the bank premium rate but do not have the flexibility to adjust the rate for savings associations, you do face the prospect of some competitive inequities. So that would be one advantage of giving the additional flexibility.

Another would just be again greater flexibility to look at conditions in the S&L, or savings association industry and be able to adjust for them.

The CHAIRMAN. Let me ask you some "yes" or "no" questions. If you can, please answer them that way. I hope you can. I would like both of you to respond. I will start with Mr. Chapin and then go back and forth with each of you.

Should the FDIC have an absolutely unlimited ability to set insurance premiums wherever they think they should be?

Mr. CHAPIN. As we have suggested, Mr. Chairman—and pardon me, I cannot quite do it on one word——

The CHAIRMAN. Yes.

Mr. CHAPIN [continuing]. I think that it would be advisable for the FDIC to be aware of the condition of the banking industry and some cautionary language I am sure would be all that would be necessary. Otherwise, I would feel happy with the FDIC's being empowered to do so.

The CHAIRMAN. To set the rates wherever they think they ought to be?

Mr. CHAPIN. Whatever they need to be, yes, sir.

The CHAIRMAN. How about you?

Mr. BOVENZI. I would agree.

The CHAIRMAN. And would that also include no statutory limit on the annual premium?

Mr. CHAPIN. I would agree.

Mr. BOVENZI. Yes.

The CHAIRMAN. So no statutory limit on the premiums is the FDIC's position, as well.

Should there be an upper limit on the ratio of insurance fund reserves to insure deposits?

Should we try to peg that, Mr. Chapin, or not?

Mr. CHAPIN. I think that what we have asked for in our bank insurance report is for a study to be made of the level of the Bank Insurance Fund. I think in looking at this fund, we tend to be trapped into historical thinking when banks were doing relatively risk-less activities, and 1.25 and 1.50 come out of that kind of environment.

I think if you look at the banks today with the risks as high as they are, and if nothing further is done to increase bank capital, that you are looking at target rates that should be much higher than 1.25 and 1.50. How much? We have not made the study, but I think Treasury is capable of doing that and should do so.

The CHAIRMAN. What is your view?

Mr. BOVENZI. I would say perhaps there should be such caps, but I do not know at this point in time what they ought to be and would not be able to give any recommendation for that, so I would not recommend doing that right now.

I would concur that determining an appropriate cap depends upon a lot of other factors which the plan is to address in comprehensive deposit insurance reform and banking industry reform, and that would allow us to get a better sense of what would be an appropriate cap.

The CHAIRMAN. Do you think the FDIC should be required to make rebates to commercial banks if and when the fund goes above the minimum?

Mr. BOVENZI. The question is above the minimum now, at 1.25?

The CHAIRMAN. Or whatever the minimum might be that is established, if it changes. The question really is, should we be——

Mr. BOVENZI. I would recommend that we be given the flexibility not to automatically give those rebates at this point in time.

The CHAIRMAN. What would be your view, Mr. Chapin?

Mr. CHAPIN. I would agree.

The CHAIRMAN. The same?

Mr. CHAPIN. Yes.

The CHAIRMAN. Very good.

I am going to give you some questions to respond to for the record. I appreciate your testimony today. Let me say this, as well.

The Congressional Research Service has prepared two reports relating to deposit insurance that are relevant to the issues that we have been discussing in today's hearings. I am going to have those reports included in today's hearing record.

So with that, we may have additional questions from members of the committee who cannot be here at this particular time. Senator Sasser, for example, is in the Budget Summit and is very busily engaged in that effort. He has a great interest in this subject. So there may be other questions that we will ask you to answer for the record.

Mr. BOVENZI. Thank you.

Mr. CHAPIN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you both for your testimony and your good work.

The committee stands in recess.

[Whereupon, at 12:52 p.m., the committee was adjourned, subject to the call of the Chair.]

[Response to written questions and additional material supplied for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM ROBERT R. GLAUBER

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

Q.1. Statements made recently by Federal Deposit Insurance Corporation (FDIC) Chairman Seidman indicate that he now believes that many ailing, undercapitalized savings and loans need not necessarily be closed. Indeed, the Chairman thinks that many of these institutions will recover once the real estate market improves. In other words, instead of spending scarce taxpayer dollars now, Chairman Seidman wants to wait and see.

I have a great deal of respect for Chairman Seidman, but his statements on this issue raise some questions in my mind.

a. First, does Treasury agree?

b. Second, doesn't this sound a lot like the discredited forbearance policies of the mid-1980s?

A.1.(a and b). In our viewpoint, it is doubtful that Chairman Seidman is advocating pre-FIRREA forbearance for undercapitalized thrifts. Prolonged and unsupervised forbearance of adequate capital standards is recognized as a significant cause of the thrift industry's current problems and is an error that should not be repeated.

c. Third, is this a shift from the previous policy of the thrift bailout under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989? To date, there have been wholesale closings of undercapitalized or insolvent institutions. Is the FDIC now saying that some of these resolutions were not necessary?

A.1.(c). The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 permits any undercapitalized savings association to apply to the Office of Thrift Supervision (OTS) for an exemption from the sanctions of penalties for non-compliance with the capital requirements. The OTS may grant exemptions from certain penalties if the savings associations have submitted an acceptable business plan. Therefore, FIRREA does provide the regulators with enough flexibility to consider well managed institutions on a case by case basis.

Q.2. I support Chairman Riegle's bank premiums bill. I too am worried about the condition of the Bank Insurance Fund. We need to do everything possible to avoid a repeat of the savings and loan fiasco. Giving the FDIC the flexibility to increase premiums, as needed, is definitely necessary.

However, raising premiums should not be a substitute for deposit insurance reform. Indeed, I have serious questions about the deposit base against which premiums are presently assessed.

Increasingly, I think that we need risk-based premium assessment. At present, money center banks that use deposits to fund loans to corporate raiders or for leveraged buyouts, pay the same deposit premiums as a community bank making home loans. In many cases it's worse. Large banks that have numerous foreign deposits pay no premiums on those deposits, yet they are de facto insured as a result of the "too big to fail" policy.

a. Please comment on this disparity.

A.2.(a). Risk-based premium assessments, the treatment of foreign deposits, and the "too big to fail" policy are all significant questions being addressed in our current study of the federal deposit insurance system.

b. Should we be changing the rules on the supplemental reserve account and rebates before we have very necessary fundamental reforms to the premium base, like risk-based premiums or assessing foreign deposits?

A.2.(b). Congress recently granted the FDIC substantial flexibility to set premium assessments, make or withhold rebates, and otherwise fund itself. The Administration was a strong supporter of this flexibility for the FDIC and does not believe these changes will prejudice further fundamental changes if needed.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
JOHN BOVENZI

FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20429
Office of Legislative Affairs

Q.1. One of the changes FIRREA made was to enable the regulators to close a bank before it becomes insolvent. The provision is intended to reduce the cost of failure to the insurance fund. The National Bank of Washington is supposed to be an example of early intervention. Then why is it costing so much to fix? Did the FDIC not know that the Bank was in so much trouble? If it knew, why was the Bank not closed sooner? If the FDIC did not know, why did it not know?

A.1. Early intervention is a helpful concept in handling bank difficulties, but it cannot prevent completely losses to the deposit insurer. One reason for losses is that the liquidation value of assets is almost always less than their ongoing value. Thus, if early intervention by the Federal Deposit Insurance Corporation results in assets being liquidated, losses are possible for the deposit insurance fund even though the bank had positive net worth at the time of the intervention. Any such losses, however, should be less than if early intervention had not occurred.

Losses incurred by the FDIC in The National Bank of Washington resolution were higher than typical for a bank of that size. This can be explained in part by rapid deterioration in real estate conditions in the Washington, D.C. area. The FDIC was not aware of the extent of the problems at NBW until a concurrent examination with the Office of the Comptroller of the Currency between May and August of 1990. The FDIC does not regularly examine banks like NBW for which it is not the primary federal regulator. Prior to the 1990 examination, the FDIC had been involved in only one of the eleven examinations of the Bank from 1984 through 1989.

Q.2. Recently, GAO expressed outrage over the handling of The National Bank of Washington and the cost of its resolution. Experience has taught that costs are high when a problem institution is kept open too long. Absent government support, uninsured depositors and creditors run and force the regulators to deal with the problem promptly, so resolution costs do not escalate. If the regulators want, however, they can keep a bank's life-support apparatus operating. To keep a bank alive, the Fed can make discount loans, as in the case of Continental Illinois in 1984. When the bank is closed, the FDIC repays the Fed. On some occasions, however, the cost has been too great for the FDIC to cover. Then the FDIC has borrowed from the Fed. In which bank resolutions has the FDIC borrowed from the Fed? Is this practice going to continue? Do you see any limits to this practice?

A.2. There have been seven troubled bank resolution cases in which the FDIC assumed a bank's debt to a Federal Reserve Bank: Franklin National Bank, 1974; Greenwich Savings Bank, 1981; First National Bank of Midland, Texas, 1983; Continental Illinois National Bank & Trust Company, 1984; First RepublicBank Corporation, 1988; MCorp, 1989; and The National Bank of Washington, 1990.

In each of these instances, the troubled institution had borrowed large amounts from the Federal Reserve. To avoid the disruption of making a huge cash outlay at the commencement of the resolution agreement -- and not because the debt was "too great for the FDIC to cover" -- the FDIC arranged with the Federal Reserve to repay the assumed debt over time.

The alternative of assuming indebtedness to a Federal Reserve Bank rather than immediately repaying discount window loans will most likely be considered in future cases involving large troubled banks. A limitation on this alternative is that it must be agreed to by the Federal Reserve.

Q.3. Some people argue that the FDIC is currently lax in enforcing the insurance rules. Under the "too big to fail policy," the FDIC makes all depositors and creditors whole. Then, fairness demands that the FDIC cover all deposits even in the smaller banks. In the short-term, this approach may or may not be cost-effective. But in the long run, it increases moral hazard, causes more risks to be taken and more losses to be made. It then raises BIF expenditures. Is it fair to demand that surviving banks pay more for their insurance because of the over-generous resolution policies that the FDIC has chosen to use?

A.3. The FDIC has neither a too big to fail policy nor an over-generous resolution policy. By law, the FDIC is required to pursue failure resolution policies that are cost-effective, and does so in every case unless the failed bank is considered essential to its community. Basically, the resolution approach adopted in each case must not be more costly than paying off insured depositors and liquidating the assets of the failed bank.

"Purchase and assumption" transactions in which all depositors are protected from loss satisfy the statutory cost test because the premiums paid by acquirers are larger than the savings that would be achieved by imposing losses on uninsured depositors. The FDIC is aware of no credible evidence supporting the contention that the current cost-effective resolution policies cause more risks to be taken and more losses to be incurred.

Q.4. Does the FDIC believe that repeal of the McFadden Act to bring about nationwide banking will increase or decrease bank risk and the probability of failure?

A.4. Repeal of the McFadden Act should decrease the overall level of risk in the banking industry. By hindering banks from diversifying geographically, the McFadden Act and the Douglas Amendment to the Bank Holding Company Act prevent banks from taking full advantage of technological innovations and market opportunities. The McFadden Act and the Douglas Amendment are impediments to the safe and sound functioning of the banking system.

Q.5. The letter of Paul Fritts on September 25, 1990 to Kenneth Guenther explains that the FDIC decided to make whole foreign depositors in The National Bank of Washington, because 51 percent of the deposits of the nation's nine largest banks come from foreign markets. Do other nations insure foreign deposits? If we are going to cover foreign deposits should we not charge premiums on them? Do the regulators not agree that a bank's heavy reliance on foreign deposits is risky and should be constrained?

A.5. In The National Bank of Washington case, the FDIC Board was presented by the staff with a new approach to resolving a failed bank situation. The staff proposed that uninsured depositors in the Nassau branch of NBW be denied protection. The Board rejected this proposal, deciding not to single out foreign depositors among the Bank's uninsured depositors. The Federal Reserve Board concurred in this action.

In four countries -- Germany, Italy, Japan, and Norway -- the deposit insurance system explicitly covers deposits in foreign branches of domestic banks. In most other countries, there is implicit coverage because bank failures are not normally allowed to occur. Troubled banks, or at least their operations, are rescued in one manner or another by the banking authorities, often in cooperation with the private sector.

The question of premiums on foreign deposits is one of the more complex and contentious issues in the area of deposit insurance reform. On the one hand, since most failure resolutions result in uninsured depositors receiving full protection, there is a very good argument that all deposits, including foreign deposits, should be assessed for insurance purposes.

On the other hand, the increased costs associated with assessments on foreign deposits might reduce the ability of United States banks to compete in foreign markets and adversely effect their ability to promote exports from the United States. In addition, many United States banks might convert foreign offices to subsidiary banks, thereby perhaps substantially reducing the amount of foreign deposits subject to assessments.

Finally, if foreign deposits are to be assessed, they should probably be insured explicitly. This raises a variety of further considerations. One is the reaction of foreign governments to United States banks offering insured deposits in competition with domestic banks. Another is the liability of the FDIC in cases where a foreign government seizes a bank's assets held in the host country without honoring local claims against the bank.

It should be noted that the issue of foreign deposits is one of the topics Congress explicitly required to be considered in the deposit insurance reform study that the Treasury Department is coordinating. The study is scheduled to be completed early in 1991.

Concerning the contention that there should be restraints on the amount of foreign deposits in a bank, the FDIC does not agree. Banking and finance are international industries and they reflect a globally integrated economy. In the long run, artificial restraints on the flow of funds, goods, and services can only have detrimental effects.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

DONALD H. CHAPIN

GAO
United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

1. In its audit study, did GAO see any evidence that the FDIC is delaying action or taking short-sighted actions because it is low on funds?

Our audit did not reveal any instances where the FDIC is overtly delaying action or taking short-sighted actions because it is low on funds. It is true, however, that the high level of bank failures over the last several years and their increasing costs are putting a serious strain on the Fund. As we reported and stated in earlier testimony before this Committee, the establishment of a number of Separate Asset Banks (SAB) raises concerns about future cash resource shortages facing the Fund when it eventually must purchase the assets remaining in these separate asset pools from the acquiring banks. One of the primary purposes for the creation of these SAB transactions was to limit the initial outlay of cash required to resolve these large problem banks. Ultimately, however, the Fund will be required to purchase any unsold assets remaining in the separate asset pool. It is expected that the ultimate cash payout will be less than what would have been required had FDIC purchased the assets outright from the failed institution due to subsequent sales of the failed banks' assets by the acquiring institution. However, proliferation of this form of assistance transaction without close monitoring of the ultimate cash impact on the Fund could severely impact the Fund's ability to deal decisively with problem institutions in the future. It is for this reason that we recommended in our report that the FDIC Chairman monitor the use of separate asset pools to ensure the Fund has sufficient cash resources to meets its commitments and future cash needs.

Additionally, based on our work, we believe the Fund faces further significant costs from a number of institutions in severe financial condition. The failure of these banks will further constrain the Fund and could force the FDIC to take less than decisive actions to deal with these institutions unless it is assured of sufficient resources to resolve all problem institutions. Therefore, we supported legislation that effectively removes the restrictive assessment rate caps in FIRREA and allows FDIC to determine the level of assessments needed to provide the Fund with sufficient resources to deal with the exposures it faces.

2. It is clear from experience with failed banks and thrifts that management is often at fault--incompetent, if not crooked. When this happens, it suggests that the institution's board of directors is also at ~~fault.~~ What are the responsibilities of the board of directors? Are you concerned that some boards of directors are not meeting their responsibilities? If this is a problem, what actions do you recommend the regulators and the Congress take?

Directors of banks and thrifts have a duty of care and loyalty in the management of their institutions to shareholders and depositors. The duty of care requires directors to act in good faith and with the care of ordinary persons in like positions under similar circumstances. It requires directors to operate their institutions in a safe and sound manner, and includes the responsibility to select and retain competent management; supervise officers and employees; establish operating policies and internal controls and take reasonable steps to ensure compliance with them; monitor compliance with applicable laws and regulations; review examination and audit reports and take steps to correct deficiencies; and avoid placing personal interest above those of the institution.

As we have noted in previous reports, we are concerned that bank boards of directors are not always meeting their responsibilities. Our previous and ongoing work on bank failures has shown that bank boards of directors have often failed to ensure implementation of adequate internal controls to foster safe and sound bank operations. Inadequate board supervision of bank management has been a contributing cause of bank failures.

We believe that the regulators and the Congress can and should take steps to ensure that directors are held more accountable for the operations of their financial institutions. Section 212 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 allows FDIC to pursue claims against directors of finanical institutions for gross negligence or any conduct that demonstrates a greater disregard of duty, including intentional tortious conduct. It also allows FDIC to pursue, under current law, claims against such directors based on simple negligence or other conduct constituting less than gross negligence. We believe FDIC should develop a policy for bringing suits against directors under section 212, where appropriate, when it believes they have failed in their responsibility to operate their institutions in a safe and sound manner. We believe such a policy, if rigorously enforced, could serve as an effective deterrent to lax supervision and monitoring of an institution's management and affairs, thereby causing directors to operate their institutions more responsibly.

In fulfilling their fiduciary duties to stockholders, bank customers, and depositors, a bank's board of directors is responsible for operating the institution in a manner consistent with safe and sound banking practices. We believe that the Congress, through legislation, should impose upon directors of federally insured financial institutions a fiduciary responsibility to protect the government's interest. Under such legislation, directors should be specifically accountable to investigate and verify the representations of bank management as to the adequacy of the institution's internal control structure and its compliance with applicable safety and soundness laws and regulations. Such responsibility would include, among other things, ensuring the adequacy of the institution's policies and practices, asset valuations, and capital levels.

We also believe that the Congress, through legislation, should require that institutions establish audit committees that are truly independent from the institution's management and board of directors. These committees should include at least one lawyer or, at a minimum, should engage their own independent counsel to serve in an advisory capacity. These committees would be responsible for reviewing the basis of the reports issued by both the institution's management and accountants and would thus help to ensure that the institution is operated in a safe and sound manner.

These recommendations are consistent with those made to this committee, both in our testimony and in our September 13, 1990, letter to the committee. We believe if these recommendations are implemented, they would greatly assist in increasing accountability by boards of directors and in improving the safety and soundness of the nations banking system.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM ROBERT R. GLAUBER

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

December 7, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, DC 20510-6075

Dear Mr. Chairman:

I am enclosing answers to the questions you submitted to me following my September 26 testimony on Federal Deposit Insurance.

We appreciate the opportunity to present the Administration's views on these issues.

Sincerely,

Robert R. Glauber
Under Secretary for Finance

Enclosure

Answers to Questions
From Senator Donald W. Riegle, Jr.

Q.1. What is Treasury's position on forbearance? Do you agree that we have learnt that keeping failed banks open too long lets them gamble with the taxpayers' money?

A.1. Treasury has long supported strong capital positions for insured depository institutions. Our experience with thrift institutions demonstrated that forbearance of adequate capital standards was an error. FIRREA addressed the problem of capital non-compliance by well-managed institutions by providing the regulator with the flexibility to impose sanctions on a case-by-case basis.

Q.2. We have seen that the Fed can prolong a terminal bank's life by lending through the discount window. The Treasury can also help out a deserving case. It can switch the government's checking and savings account balances (called Treasury Tax and Loan (TT&L) accounts) to a troubled bank. Who decides where TT&L account balances are kept? What criteria are used to determine where the money is placed? How often is the set of chosen banks reviewed and changed? Have Treasury funds been used to fund banks experiencing funding resistance elsewhere? Are TT&L balances backed by collateral? What kinds of collateral are accepted? Are government balances ever backed by insufficient or inadequate collateral?

A.2. There is a distinction between "the government's checking and savings account balances" (quoting from Q.2.).

The Treasury General Account system is the Treasury checking account, roughly speaking. (See 31 CFR Part 202 and the laws referred to therein). The Treasury Tax and Loan Account system is the Treasury savings account, roughly speaking. (See 31 CFR Part 203 and the laws referred to therein).

The Treasury General Account system includes Treasury collection accounts at qualified financial institutions which feed into, on a daily basis, the Treasury accounts at the Federal Reserve Banks. The Treasury Tax and Loan Account System has two components: The first is funds representing Federal Tax Deposits credited to interest-bearing note accounts at qualified financial institutions which are maintained for varying time periods until called by Treasury; the funds may be deposited by particular classes of taxpayers or they may be directly invested by the Treasury Department through the Federal Reserve Banks. The second component is funds which are remitted by financial institutions on an expedited basis to the Federal Reserve Banks for credit to Treasury.

We understand your questions to apply to the Treasury Tax and Loan Account System, and to the note account alternative.

Q.2.(a). Who decides where TT&L account balances are kept?

A.2.(a). Taxpayers, and the Federal Reserve Banks acting as Treasury agents. The locations of TT&L account balances are determined by the locations of the financial institutions at which corporate/business taxpayers decide to make tax payments. As well, periodically, Treasury makes direct investments (deposits) from the Treasury's Federal Reserve operating account with depositaries maintaining TT&L note accounts; these deposits are made through the Federal Reserve Banks only when Treasury has excess cash in its operating account and only to the extent that the depositaries are interested and able to pledge eligible collateral to secure 100% of the balances in the note accounts.

Q.2.(b). What criteria are used to determine where the money is placed?

A.2.(b). By taxpayers: their convenience, cash management considerations, etc. By Treasury: collateral security availability and the amount of its excess operating cash. As indicated above, Treasury does not determine where TT&L deposits are made by taxpayers. Treasury does not know the identity of the individual depositaries receiving direct investment funds. Treasury is aware of (1) the total amount of collateral available Federal Reserve Systemwide to secure additional balances (capacity), and (2) the amount Treasury wishes to directly invest. Treasury determines what percentage (2) is of (1), and the Federal Reserve Banks are instructed to provide each depositary participating in direct investments that same percentage of its individual capacity.

Q.2.(c). How often is the set of chosen banks reviewed and changed?

A.2.(c). As stated above, Treasury does not choose banks to participate in the TT&L program, nor to receive direct investments. Depositaries apply to the Federal Reserve Bank of their districts to be authorized to participate in the TT&L program. To be authorized by Federal Reserve Banks to receive direct investments, depositaries must be willing to accept direct investments and to fully collateralize these additional deposits.

Q.2.(d). Have Treasury funds been used to fund banks experiencing funding resistance elsewhere?

A.2.(d). No. Treasury places direct investments only when it has excess operating funds in its Federal Reserve operating account, and only with depositaries that are able to fully collateralize the funds. Each depositary participating in the direct investment program receives an equal percentage of its capacity to collateralize additional deposits. Any liquidity problems that an individual bank might experience are transparent to Treasury. (Treasury is not at risk when TT&L balances are adequately collateralized.)

Q.2.(e). Are TT&L balances backed by collateral?

A.2.(e). Yes, by law and regulation. A depositary must collateralize all balances in the TT&L account in excess of recognized insurance coverage and 100% of the balance in its TT&L note account.

Q.2.(f). What kinds of collateral are accepted?

A.2.(f). Section 203.15 of Part 203 of the Code of Federal Regulations lists the types of securities that are eligible for TT&L collateral.

Q.2.(g). Are government balances ever backed by insufficient or inadequate collateral?

A.2.(g). Occasionally, for short periods of time. Treasury has provided the Federal Reserve Banks with effective, detailed daily and monthly policing procedures to identify those depositaries that are frequently undercollateralized and to bring them into compliance with collateral requirements. The procedures recognize the volatility of the flow of tax payments and accordingly tolerate occasional deficiencies for very short periods of time. Treasury and the Reserve Banks work closely and quickly to correct collateral deficiencies. Treasury's risk of a loss of funds due to a bank failure is minimized by (1) Treasury regulations requiring full collateralization, (2) a maximum balance feature for note option depositaries (72% of the total TT&L dollar flow), and (3) the daily and monthly collateral policing for collateral deficiencies by the Reserve Banks.

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CRS Report for Congress

Deposit Insurance Reform: Evaluating the Proposals

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August 27, 1990

CRS

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DEPOSIT INSURANCE REFORM EVALUATING THE PROPOSALS

SUMMARY

Having absorbed between $100 and $200 billion in losses as a result of insuring deposits at insolvent savings and loan (S&L) institutions, the Federal Government is reexamining its deposit insurance system. A number of changes have been suggested. This report examines the principal competing proposals.

The economic justification for deposit insurance lies in its ability to prevent banking panics and the macroeconomic instability that panics induce. But insuring depositors removes some of banks and thrifts' incentive to avoid risk. Without some way of restoring this incentive, the result will be resource misallocation.

Three approaches exist to deal with this incentive problem. First, deposit insurance can remain largely unchanged and regulation can restrain the tendency toward too much risk. Second, deposit insurance can be scrapped and macroeconomic stability achieved by other means. Last, insurance could be reformed in order to restore some of the lost incentives.

Regulating the industry more closely may shift the nature of the microeconomic inefficiency without getting rid of it. Macroeconomic stability may also be undermined by the emergence of close money substitutes in less restricted uninsured institutions.

The effectiveness of discipline through supervisory regulation can be obviated by political intervention in the process. When decisions to discipline or close institutions must be made, a tendency may exist for pressure to placed on officials to forbear in consideration of special circumstances.

Eliminating insurance and relying on the Federal Reserve as a "lender of last resort" would only change the institutional locus of the decision to deal with a troubled institution. The informational requirements are largely the same as under deposit insurance.

Mutual deposit guarantees offer stability comparable to that of the current system. It is a system that provides a measure of regulatory flexibility and removes many critical decisions from direct political and bureaucratic influence. It is not, however, totally without need of supervision.

Variable rate deposit insurance premiums could replace the incentives removed by insurance. But there must be a means to set the prices. An active reinsurance market could assist in this.

Limitations on the benefits provided by deposit insurance could reintroduce discipline at the margin. Some macroeconomic stability would be lost under these reforms. More important, they are highly interdependent; some do little by way of reform without the adoption of others. In particular, the too-Big-to-fail problem affects most of the proposals. Finding a workable solution to too-Big-to-fail is critical for limitations on insurance benefits to work.

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DEPOSIT INSURANCE REFORM: EVALUATING THE PROPOSALS

Having absorbed between $100 and $200 billion in losses as a result of insuring deposits at insolvent savings and loan (S&L) institutions, the Federal Government is reexamining its deposit insurance system. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), among other things, mandates studies of deposit insurance by the Treasury Department and the General Accounting Office (GAO).

Already, a number of proposals have been advanced. They range from extending deposit insurance coverage to eliminating it altogether. Many of these proposals are inseparable from proposals to restructure the financial services industry. This report examines the principal competing proposals for reform of the deposit insurance system. In doing so, it first explains why reform is being proposed, and presents an analytical framework that permits the evaluation of different plans.

The first section of this report explains the role deposit insurance plays in the economy and the problems that its existence generates. The second section briefly describes the current insurance system. In the third section of the report, the various proposals for change are examined. These are divided into three categories: first, proposals to leave the basics of deposit insurance the same but correct for the problems that insurance creates in other ways; second, proposals to get rid of the problems caused by deposit insurance by doing away with it altogether, and then fulfilling its role by other means; and finally, proposals to modify deposit insurance by changing either the way in which its costs are assessed on banks or by changing the benefits that accrue to depositors. A conclusion follows.

THE NATURE AND PURPOSE OF DEPOSIT INSURANCE

All modern economies depend on financial intermediaries to match savers with borrowers. At its simplest level, such intermediation occurs through brokers, who purchase securities with funds entrusted to them by individuals or institutions. But a variety of other institutions perform the same basic function in other ways.

DEPOSITORY INSTITUTIONS

Among such intermediaries, depository institutions such as banks and savings and loans (S&Ls) are special in two important and related ways. *First*, potential for "runs." The *second* means that the runs can have dire monetary consequences.

If customers believe for some reason that a bank does not have sufficient assets to cover its deposits, they will conclude that money left on deposit at the bank is not safe. Because deposits are redeemed at par or not at all, those who withdraw their funds first will get them. Those who wait may well find nothing left for them to withdraw. If suspicion falls on a bank's soundness, it therefore makes sense to withdraw deposits as quickly as possible. When many depositors react this way, the result is a run on the bank.

Moreover, a bank does not actually have to be unsound for this to present a problem. If many depositors fear for their deposits and insist on withdrawing their money, even a sound bank will not have the funds on hand to satisfy them. In some instances, when the bank tries to sell off assets to satisfy depositors' demands for their deposits, it may incur losses because the "fire sale" nature of its efforts prevents it from obtaining good prices for its assets. Thus, depositor fears may become self-fulfilling. Moreover, the experience of one failed bank may cause doubts to be raised about others, so that more runs occur. A general panic consisting of many bank runs can be the result. Worse still, the massive dumping of bank assets on financial markets can depress asset prices enough to cause balance-sheet problems for yet other banks, prompting yet more runs.

Even if banks are sound and remain sound throughout the panic, a banking panic can still have profound effects on the economy through the behavior of the money supply. Just as a small amount of cash deposited in a bank can eventually generate a much larger amount of deposit money, a small amount removed can reduce deposits by a much larger sum. In a banking panic, when deposits are converted into currency on a massive scale, the total money supply shrinks precipitously because the multiple expansion of deposits is turned on its head. The result of such a sudden reduction in the supply of money is usually a severe contraction in economic activity, in which output and employment fall.

THE ROLE OF DEPOSIT INSURANCE

One way of avoiding banking panics and the economic disruption that they generate is through deposit insurance. A guarantee of the value of deposits can prevent bank runs and banking panics if the guarantee is both credible and provides depositors immediate access to their funds. With a guarantee, depositors do not have to fear the loss of their funds and have no incentive to run on an institution.

Deposit guarantees are not the only method of avoiding the economic costs of banking panics. A panic may be arrested by suspending depositors' right to convert their deposits to currency or by temporarily suspending all activities of the banks (a "banking holiday"). These methods, however, by increasing the

THE ECONOMIC DRAWBACKS OF DEPOSIT INSURANCE

A guarantee of deposits by means of insurance bears an economic cost. If credible, it prevents all runs regardless of cause, and "bails out" institutions that have become insolvent. But a market economy, to be efficient, needs the discipline of business failure as a penalty for poor performance. A retailer is motivated to provide good service by the prospect that business may decline if it does not; and a manufacturer is led to monitor quality due to the threat of sales losses if its goods are shoddy.

Runs on banks play an analogous role by motivating banks to invest in a way more consistent with depositor wishes. So an uninsured bank has incentive to invest funds carefully lest it lose deposits. If the incentive to remove deposits from an unsound bank is removed, then the incentive for a bank to avoid overly-risky investments is partially removed as well.

Thus, insurance, by indiscriminately protecting depositors regardless of the riskiness of their bank's lending behavior, leads to incentive problems. Owners of a bank have only their equity at risk in its operations; yet they earn profits from the investment of their depositors' money as well as their own. If depositors are not actively concerned about the riskiness of bank investment, then the lending decisions are made by bankers whose potential for loss is small in proportion to their potential for gain, and whose preference for or aversion to risk is very different from that of depositors. The result will tend to be an increase in the amount of risky lending engaged in by the bank — an amount larger than it would be in the absence of insurance.

The fuller and more complete the coverage of insurance, the greater this problem is likely to become. Cover some deposits or parts of them and some incentive remains with depositors to monitor the risk characteristics of the bank. Cover all the deposits, and no incentive is left for deposits to police bank lending. If failing banks are rescued in their entirety, so that other creditors besides depositors are protected, the incentive problem becomes even worse.

The incentive problem is important because resources lent to more risky ventures are resources no longer available for use in less risky ones. So that the existence of deposit insurance alters the allocation of funds among various investment projects. An economic cost from insurance, then, is incurred when this reallocation results in a less than efficient use of resources for investment.

Deposit insurance may be incurring these economic costs even when it is not imposing large obligations on the taxpayer. In real terms the costs are experienced as resources spent on structures built in locations where they are less needed than in others, or to be used for purposes less productive than others. This cost may never manifest itself in the form of a default because the borrower absorbs the less-than-expected profits. If borrowers lose so much that they default, the loss may still be incurred primarily by the owners of the bank so that the insurance funds aren't involved. If insurance must be paid out for losses, the cost need not be like the recent S&L episode, in which additional

Association Insurance Fund (SAIF).[2] Coverage is up to $100,000 for each individual's accounts in each institution.

That coverage is made more complete by three other factors. First, because an individual gets insured for each deposit at a different covered institution, by spreading out investments or through a deposit broker, far more than $100,000 per person can be insured.[3] Second, when an institution fails, instead of liquidating it, the FDIC often finds it cheaper to merge the institution into another -- healthy --institution, paying the healthy partner in the merger enough to make up for the bad assets of the troubled partner. The result effectively insures all deposits. Third, some institutions are considered too large to fail because their failure would be too disruptive to financial markets. Implicitly, their deposits are fully insured because authorities are considered likely to step in and prevent default if it were about to occur. Thus, *de facto* deposit insurance coverage in the United States is very high.

Banks and S&Ls pay a fixed percentage of insured deposits in the form of insurance premiums. The rate for banks is currently 0.12 percent (to rise to 0.15 percent in 1991). The rate for S&Ls is 0.208 percent (to rise to 0.23 percent during 1991-1993 and then to fall to 0.18 percent through 1997, after which it falls to 0.15 percent). This percentage is fixed legislatively and does not vary to reflect the relative risk of an insurance claim.

Authority to close institutions or place them in the hands of a receiver resides with the chartering agency. This could be the Office of the Comptroller of the Currency (OCC) in the case of a federally chartered bank, the Office of Thrift Supervision (OTS) in the case of a federally chartered Thrift, or State regulatory authority in the case of State chartered institutions. Before acting with respect to an institution that is insolvent or threatens to become so, the FDIC must coordinate its actions with the relevant chartering authority.

REFORM PROPOSALS

Proposals for reform of the deposit insurance system are rooted in the basic dilemma described in the first section of this report: uncertainty of repayment of deposits engenders macroeconomic instability, but protection against bank runs creates microeconomic inefficiency. The general perception is that the efficiency cost has become particularly burdensome. Thus, redesign of the or reserves with the Fed. All transactions accounts would have to be held in such institutions. There would be no defaults or interest rate changes to cause the bank to lose money. Service charges would constitute the bank's revenue.

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[2] Credit Union accounts are insured through the National Credit Union Share Insurance Fund.

[3] Note also that a household may have several insured deposits at the same institution. There may be two insured accounts, each in the name of one spouse, a joint account in the name of both spouses, and other joint accounts in the names of parents and children.

Alternatively, the institution might be limited to a slightly wider (though by current standards quite narrow) range of assets. Government securities are riskless with respect to default, and -- if short enough in maturity -- are also virtually free of fluctuations in value due to changes in interest rates. Banks could be limited to these as their only assets. Other relatively low-risk investments might also be included under some proposals.

A significant advantage to this approach is that deposit insurance can be extended to deposits of any size without additional loss of discipline on bank and thrift behavior. Discipline under this plan comes from the restrictions imposed on the banks, not depositors. Thus, a common complaint by small banks -- that large banks being "to big to fail" have the competitive advantage of *de facto* complete coverage without having to pay extra for it -- can be addressed with explicit unlimited coverage without increasing risk-taking behavior.

Several disadvantages attend the narrow bank option, however. First, if banks are constrained to a very narrow menu of investment activities, depositors would earn significantly smaller yields on their accounts (even to the point of having to pay fees instead of earning returns). This would drive some customers, if not most, to look to place their money in nonbank institutions with higher returns.

Even before the creation of deposit insurance, there existed options for the public to protect its money. For example, there were postal savings banks. Yet, a large segment of the public still preferred commercial banks. Similarly, even though the banking system in earlier times was free to evolve into a system of "safe" institutions, had customers exhibited such a preference, it did not. One can conclude that while deposit safety is important, so is cost. And as long as the option of higher-yield uninsured deposits are available, a significant fraction of the public will place funds in them; and as a consequence, the financial system will be at risk of a panic. Thus, if the banking system is to be set up around narrow or core banks, care must be taken to minimize the availability of closely substitutable financial institutions that are not insured.

This leads to the second problem: system inflexibility. The existence of consumer demand for higher returns would cause the financial system to come up with new means of supplying the demand outside the constraints of narrow banks. And no matter how well crafted the new banking system were, innovations would emerge in response to this demand. The system would therefore require constant legislative fixes to keep it intact. This is usually a slow -- sometimes too slow in terms of financial stability -- process. One should recall that widespread S&L insolvencies of the early 1980s were largely due to the industry's

Supervisory Regulation

Instead of narrowly restricting bank lending activity, it is possible to apply regulation in a more flexible manner through frequent examinations and constant supervision within the current legislated framework or some slightly modified version of that framework. A number of observers favor this approach, explicitly or implicitly.[8]

Supervision could take the form of prohibiting banks and thrifts from investing in certain categories of assets. More often, banks would run into problems with regulators for relying too much on certain categories of assets. The supervision would not ordinarily extend to a direct involvement in the allocation of credit. Individual loan decisions would not have to be approved, nor would they necessarily be second guessed. Nonetheless close supervision could be considered a flexible form of credit allocation.

This approach has the basic advantages of the first option discussed, while reducing considerably the disadvantages associated with it. Supervisory regulation can react more quickly to innovations in the financial industry than could regulation by legislative restriction. At the same time, it would not be characterized by the degree of centralization of credit allocation that occurs when institutions are narrowly restricted to a few types of lending. Yet, the same problems are still there, and it is not clear whether they would be small enough to be outweighed by the advantages.

When the banking system is able to make its own choices about its lending, each bank represents a sort of appeals board to which every potential borrower can take his case if turned down elsewhere, imparting a degree of pluralism to the lending decision. But regulators and examiners, while they would not direct institutions to accept or refuse specific loans, would influence the kind of lending that occurs. When regulators frown on a particular kind of investment, they do so for all lenders. And the system tends to become monolithic.

The recent experience with the so called "credit crunch" in late 1989 and early 1990 illustrates this point. By winter 1990 there were widespread complaints from New England and several Eastern U.S. metropolitan areas that banks were refusing to lend to borrowers with good credit histories,

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[8] By implicitly, it is meant that fundamental reforms of the system itself are not recommended so that the burden of disciplining bank and thrift lending behavior falls on supervision. Examples of this may be found in Vallandingham, Philip (Independent Bankers Association of America). Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. April 24, 1990; and Clarke, Robert (Comptroller of the Currency). Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. July 31, 1990. Clarke favors legislative restrictions as well, not so much to move the industry toward narrow banks as much to keep them from widening into "universal banks."

Capital Standards, Prompt Intervention, and Branching

Several reforms are mentioned frequently as means of decreasing the microeconomic efficiency cost of deposit insurance. These are not fundamental reforms of deposit insurance itself, but either affect the way it is administered, or relate to institutional solvency in other ways. Three of these are high capital standards, loosening restrictions on branch banking, and prompt intervention to deal with institutions that are insolvent or nearly so.[12]

Capital Standards

Capital is the sum advanced and put at risk by the owners of the institution. It does not consist of idle balances not lent out. Instead, it represents the first cushion in the event of losses. In the event of losses from the operation of an institution, the owners lose their money first, after that any additional losses may fall on uninsured creditors, including deposits above the $100,000 ceiling. In theory, it is only after those groups have absorbed all the losses they can that the FDIC has to pay out anything to protect depositors.

One will note that the higher the capital requirement, the more owners have at stake in the institution. More than acting as a cushion for losses, the capital provides incentives to the owners to operate their institution in a sound manner. A higher capital ratio presumably decreases the willingness of the owners to take risks in lending, because they stand to lose more in the event that loans go sour.

A depository institution is by nature highly leveraged, that is, it operates largely on borrowed money. If it did not, it would not be a depository institution. Owners will make money based on all the funds they lend out, especially that of depositors; but they can at most lose only their own. Consequently, the potential for gain and loss with respect to any given risky investment is asymmetrical. A built-in incentive for risk-taking exists as long as depositors do not have any reason to restrain the owners' risk-taking proclivities. Thus, short of a capital ratio of 100 percent -- which is to say, making banks something

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[12] Recommendations for tough capital standards and quick intervention are nearly universal. See Scott, Kenneth (Stanford University). Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. May 17, 1990; Kaufman, George (Shadow Financial Regulatory Committee) Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. May 22, 1990; Whipple, Kenneth (Financial Services Council) Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. April 24, 1990; and Bryan, Lowell. Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. May 22, 1990. Support for eliminating branching restrictions can be found in Chisholm, Jeffrey (Bank of Montreal). Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. June 13, 1990; and Scott (cited above).

Branching

While not directly related to deposit insurance, prevalence of restrictions on banks' and thrifts' ability to have branch offices is important to the issue of insurance reform because it affects the likelihood of insolvency. A number of States prohibit banks from having more than one retail office. Most do not permit banks from other States to open branches within their borders (or do so within narrowly defined regional pacts). As a result, the United States does not have any truly "national" banks in the sense of an institution operating across the Nation.

The more restricted the geographic reach of an institution, the more narrow the economic base in which it is likely to operate. This tends to inhibit the diversification of loan portfolios. Thus many banks' success rides critically on the economic performance of the region in which they are located. The price of oil or the health of the farm sector, for example, can determine the prospects of bank failure to a much larger degree under the current arrangement than in a widely branched system.

This property is exhibited in historical and international experience. Bank failures and runs in the United States before the advent of deposit insurance tended to be more common in States that had branching restrictions.[15] Similarly, the experience with failures in Canada, where such restrictions do not exist, has generally been better than in the United States, even in the great contraction of 1929-33.[16]

While a general consensus exists among economists that nationwide branching would reduce the likelihood of bank failures, branching does not solve the underlying incentive problem created by deposit insurance. Branch banking is at best a complement to -- not a version of -- deposit insurance reform.

Summary

In short, capital requirements and prompt closure of unsound institutions are widely agreed upon methods of cutting down the microeconomic costs generated by deposit insurance. Nationwide branching is also believed by most analysts to be a reform that would decrease the likelihood of failure among depository institutions. Yet, none of these (nor all together) is likely to be sufficient to offset the allocational resource costs associated with the existence of deposit insurance.

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[16] Calomiris, Charles. Is Deposit Insurance Necessary? A Historical Perspective. *Journal of Economic History*. June 1990. pp. 283-296.

[16] See Haubrich, Joseph. *Nonmonetary Effects of Financial Crisis: Lessons from the Great Depression in Canada*. Unpublished paper. June 1989.

How advantageous this is depends on whether depositors really can discipline banks. They must not only have an incentive to withdraw their funds from an unsound institution, they must have the information necessary to determine which institutions are and are not sound. Depositors' propensity to run on an institution must be related to the institution's financial condition for discipline to be imposed. If runs occur randomly, then no penalty results from risky lending behavior; healthy and unhealthy banks alike would face equal chance of a run.

The historical evidence on the ability of depositor's to monitor the condition of banks and their willingness to move their deposits on the basis of that information suggests that it can be effective. A large body of literature reassessing the experience with free banking indicates that a banking system can work fairly well even without a lender of last resort, that consumers do pay attention to their bank's condition, and that banks respond to the discipline that depositors thereby create. [17]

But any plan that relies on depositor discipline also depends on whether the market is allowed full scope to impose that discipline. The lender of last resort must limit its assistance to illiquid institutions. If insolvent institutions were also aided in the event of a run, then the same problem would be created as with deposit insurance: the prospect of a run no longer serves as a deterrent to risky lending practices. Thus, if reliance is placed on the lender of last resort function to achieve macroeconomic stability, the central bank must be able to distinguish insolvent from simply illiquid institutions.

These are the same informational requirements faced by an insurer, which also must know when a bank becomes insolvent in order to close it down. But because insurance tends to eliminate runs, an insurer usually has more time to make a determination on the institution's financial condition. A lender of last resort must be able to make a determination at the time a run occurs[18], and runs usually occur with little advance indication. Thus, sole reliance on the lender of last resort -- if depositor discipline is to be maintained -- would require the Fed to constantly monitor institutions with respect to their solvency.

In some sense the Fed must do this already. Since some deposits are not insured, banks do occasionally experience silent runs -- withdrawals of large uninsured deposits. When this happens, if it occurs quickly enough, the Fed must know the condition of the institution in order to intervene. But these

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[17] See for example White, Lawrence H. *Free Banking in Britain; Theory, Evidence, and Debate, 1800-1845*. Cambridge. 1984. 171 p. Also see Rolnick, Arthur and Warren Webber. New Evidence on the Free Banking Era. *Journal of Monetary Economics*. November 1984. pp. 267-91; and Economopoulos, Andrew. Illinois Free Banking Experience. *Journal of Money, Credit, and Banking*. May 1988. pp. 249-264.

[18] Keep in mind the observation made earlier, that prevention of panics depends not just on guaranteeing deposits, but making funds available immediately.

Ultimately this arrangement would place the capital of the entire industry behind deposits as a guarantee. Ely provides evidence that capital in the industry is large enough to absorb any likely loss. According to his analysis, there was even enough capital in the industry to have handled the losses of the great contraction of 1929-33.

Under most private insurance proposals, macroeconomic stability is a problem; concerns with the solvency of the bank are merely exchanged for concerns about the solvency of the insurer. As experience with Maryland and Ohio's deposit insurance systems proved, doubts about the insurer are enough to launch a panic. The cross guarantee plan appears to avoid this difficulty. First, if Ely is right, there are enough funds to safeguard the system even through the worst economic conditions. Second, there remains an FDIC backstop that should be enough to ensure public confidence.

From the point of view of microeconomic efficiency, the plan is noteworthy in a couple of respects. It relies neither on depositor discipline nor regulation. Discipline comes from the rest of the industry. Under the proposal, guarantors have both the incentive and the expertise to monitor insured institutions. Moreover, the discipline is exerted well before any decision to close a troubled institution occurs. As an insured institution moves in the direction of riskier lending, the likely response will be an increase in the fees that it must pay to the consortium of guarantors. If this fails to change the way in which management conducts business, the higher fees will show up as lower profits, at which time stockholders can be expected to pressure management to change. If still this does not work, deteriorating performance of the institution would lead to the action by the guarantors to close it, before large losses are accumulated.

The role for either political intervention or bureaucratic inertia to slow down the process of dealing with troubled institutions is considerably reduced by placing the decisions in the hands of the guarantors. Historical evidence from earlier deposit insurance systems built around mutual guarantees supports Ely's contentions in this regard. Bank clearinghouses of the nineteenth and early twentieth centuries had aspects of the mutual guarantee system and brought considerable stability.[20]

At the same time, much regulation of the industry would become unnecessary. The constant monitoring of guarantors would help ensure sound banking practices while the variety of contracts, and large number of institutions would tolerate more variations in behavior by institutions. Indeed all incentives would tend to deliver the kind of behavior most desired: higher capital rations, premiums varying with risk, prompt closure, price signals that change behavior before losses become too great.

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[20] For the role of clearinghouses in promoting stability, see Gorton, Gary. Private Clearinghouses and the Origins of Central Banking. *Federal Reserve Bank of Philadelphia Business Review*. January-February 1984. pp. 3-12.

accordingly. At too high a level of risk, the higher premiums would wipe out any gains from the riskier lending; profits would shrink.

Assessing risk is difficult though. It puts insurers in the same dilemma as regulators, second-guessing bank decisions. Premiums can be established along broad risk categories like capital standards, but beyond this assessing risk is inherently subjective.

A method of addressing this would be to have the FDIC purchase reinsurance. It could sell its risk on the open market and thereby get an idea of the cost by what it must pay. This borrows from the strength of private insurance while at the same time retaining the essential element of a certain Government guarantee (if the reinsurer defaults, the Government still pays).

Note that in terms of basic economics, this is the same as the Ely mutual deposit guarantee plan. Ely organizes the institutions into a pricing system with a backup and supervisory role for the FDIC which amounts to the same thing as FDIC insurance with private reinsurance. In the event of a failure under either plan, the private insurers pay off. Only in event of ultimate failure of these does Government pay.

Ely's plan has the advantage that the basic insurance contract is not uniform since contracts originate among private parties. It further has the advantage that most of the decisions to act are made by private parties. Risk-based FDIC insurance with reinsurance has the advantage that reinsurance can be less than complete and create no problems for the system. Ely's plan faces real difficulty if insufficient private guarantors can be found to insure the entire industry.

Benefits

There are several ways of altering insurance with respect to the benefits it provides instead of costs. These reform proposals are built around the principle of depositor discipline. The basic idea is that limiting the coverage in one way or another increases the concern that depositors must have for their funds and motivates depositors to monitor the condition of institutions.[22]

(continued) risked-based premiums are Bryan, Lowell (McKinsey and Co.). Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. May 22, 1990; and Kaufman, George (Shadow Financial Regulatory Committee). Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. May 22, 1990

[22] Opposition to virtually any reduction in coverage comes from Miller, Peggy (Consumer Federation of America). Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. April 18, 1990; Ettleson, Sherry (Public Citizen). Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. April 18, 1990. and Scott, Kenneth (continued)

One approach is to run all resolutions through a stage of conservatorship in which ultimate management responsibility lies with the insurer. Even though the institution would ultimately be sold (as in the case of the assisted merger) or otherwise allowed continued operation, the insurer would immediately reduce the institution's uninsured liabilities by means of a "haircut": based on some percentage representing an estimate of how insolvent the institution is on past experience with insolvencies, all uninsured liabilities would be marked down to a percent of their nominal value.[24]

Note that operation of the institution would not have to be interrupted. An institution too important to suffer a lapse of operations would not. But the insurers would move in on, say, a Friday, and on Monday every uninsured depositor would find his account only worth a fraction of what it had been the week before.

The institution could then be sold as a single entity with the newly denominated accounts. In the case of a huge institution, the insurer would be the temporary owner, selling shares in the institution after recapitalizing it. No interruption of operation would be required.

Regardless of whether this approach were taken or not, too-big-to-fail presents real problems to the deposit insurance system. Depositor discipline is unlikely to be effective in its presence. If it is to remain, then a case for formally recognizing it and charging premiums for the additional insurance can be made.

Deposit Brokers

Deposit brokers help route depositor's money to the highest yield institutions. This can be in amounts of less than $100,000 for smaller investors simply seeking the highest return. For amounts larger than $100,000, a broker breaks up the depositor's money and distributes it among several high-yielding institutions so that all of the money is insured.

The broker therefore will be depositing large sums of money, potentially many millions of dollars in an institution. But because the deposit owners are nominally the individuals whose money it is, the sum is insured. This makes

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(continued) are skeptical whether anything can be done about the doctrine. See Vallandingham, Philip (Independent Bankers Association). Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs. April 24, 1990.

[24] The haircut solution is embodied in the ABA's proposal on how to deal with too-big-to-fail (see Labrecque). An extensive discussion of the proposal and technical difficulties posed by it are found in Seidman, William (Federal Deposit Insurance Corporation). Appendix to Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. July 31, 1990.

likely to be the most sophisticated in their ability to evaluate each other's condition, this would impose some depositor discipline.[27]

The discipline, however, would apply only to the banks that rely heavily on interbank deposits. Moreover, the system would be made more susceptible to a domino effect, in the sense that one failing large bank would impose losses on many other smaller banks. Also, for this reform to have a salutary effect, something would have to be done about too-big-to-fail.

Lower Ceiling

The idea of a deposit insurance ceiling lower than $100,000 is similar in principle to the two options just discussed.[28] A lower ceiling doesn't change much except the exact class of depositor that is expected to impose discipline. If on average, ability to judge bank portfolio behavior rises with the amount of funds available for deposit, lowering the ceiling increases the chance of random runs. The lower the ceiling, the more the system would approximate a system with no insurance at all.

To make any difference, however, too-big-to-fail and deposit brokers would also have to be addressed, otherwise the lower ceiling would be ineffective.

Coinsurance

One proposal is to cover deposits to a certain extent only, say 75 or 90 percent. This way the depositor is protected from total financial disaster but faces some losses in the event of a failure.

In comparison to the other options, this proposal would tend to create more instability in exchange for no more efficiency. Note that with coinsurance of this type, no one's incentive to run on a bank or thrift is eliminated in its entirety. Consequently, every depositor, from the smallest to the largest, is expected to provide discipline. In general, however, one would expect the smaller depositors to be the least proficient in monitoring a bank's condition. Consequently, in comparison to full coverage up to a ceiling,, this option has a much higher chance of a panic for any given amount of exposure to loss by the insurer.

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[27] Uebelhoer goes further, proposing to limit insurance to individuals only, so that even corporations would not be eligible. Uebelhoer, Jane (Association of Community Organizations for Reform Now). Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. April 18, 1990.

[28] In real inflation adjusted terms, the current $100,000 ceiling is more than three times the value of the $2500 ceiling set in the 1933 legislation creating the FDIC.

Summary

Proposals to change the coverage of deposit insurance are primarily aimed at depositor discipline. They represent in each instance a compromise between the goals of macroeconomic stability and microeconomic efficiency. This compromise occurs not just because incomplete coverage makes runs more likely. For some proposals, the actual implementation of the reform impose such difficult technical requirements (e.g. haircuts and per-depositor limits) that the ability to make funds immediately available to depositors in the event of a failure may be hindered. Delay in receiving funds can be as conducive to runs as not getting one's money at all.

Moreover, many of these reforms are likely to be ineffective unless combined with others. Lowering the ceiling may be of little help without doing something about deposit brokers. Per deposit limits are likely to have little influence on bank lending behavior without something done about the too-big-to-fail doctrine.

CONCLUSION

The economic justification for deposit insurance lies in its ability to prevent banking panics and the macroeconomic instability that panics induce. But insuring depositors removes some of banks' and thrifts' incentive to respect risk. Without some way of restoring this incentive, the result will be resource misallocation.

A general consensus exists that the balance between these two considerations has shifted too far against microeconomic efficiency. This view is underscored by the huge taxpayer costs incurred through losses in the S&L industry. Three approaches exist to restore this balance. First, deposit insurance can remain largely unchanged and regulation can restrain the tendency toward too much risk. Second, deposit insurance can be scrapped and macroeconomic stability achieved by other means. Last, insurance could be reformed in terms of the premiums paid in or the benefits paid out in order to restore some of the lost incentives.

Regulating the industry more closely may simply shift the nature of the microeconomic inefficiency without getting rid of it. Limiting the range of assets that banks and thrifts could hold would be a form of credit allocation that might be as costly in efficiency terms as the present system. This is especially true under the core or narrow bank proposals.

Under narrow or core bank proposals, macroeconomic stability may also be undermined by the emergence of close money substitutes in less restricted uninsured institutions.

Discipline through supervisory regulation helps deal with both of these problems compared to legislative restrictions. But supervision may be more susceptible to political considerations. When decisions to discipline or close

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CRS Report for Congress

Federal Bank Regulators' Positions on 1980 Deposit Insurance Increase to $100,000

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FEDERAL BANK REGULATORS' POSITIONS ON 1980 DEPOSIT INSURANCE INCREASE TO $100,000

Summary

Questions have been raised as to how the various federal bank regulators reacted to a proposal to increase federal deposit insurance coverage to $100,000 in 1980. The increase of federal deposit insurance coverage in 1980 from $40,000 to $100,000 derived from a Senate floor amendment to legislation that primarily dealt with interest rates deregulation. There was, thus, very little consideration of an increase in the Committee deliberations prior to the Conference Committee's incorporating an increase to $100,000 in the final version of the legislation.

With respect to how the federal depository institution supervisory agencies viewed an increase in deposit insurance coverage, there is limited evidence. Senator Cranston, who introduced the original amendment, which would have raised deposit insurance to $50,000, stated that the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation, administrators of the bank and thrift insurance systems, favored the initial increase. Earlier, during hearings connected with the general deregulation legislation, there was espousal of a $100,000 deposit insurance limit by the Board of Governors of the Federal Reserve System and testimony by the Federal Deposit Insurance Corporation generally favoring an increase linked to inflation and acceding to an increase to $100,000 provided the agency was given authority to increase the effective rate of premium assessments imposed on insured banks. There was also some testimony by the Comptroller of the Currency indicating no particular opposition to an increase. Finally, there are some post enactment statements indicating that some of the agencies acquiesced in the increase. The final legislation, it might be added, included not only the $100,000 increase but also an altered formula for refunding the assessments levied upon the insured depository institutions; whether that was sufficient to have obtained wholehearted approval by the Federal Deposit Insurance Corporation for the entire $100,000 increase is unclear. The percentage of the assessments that the Federal Deposit Insurance Corporation could retain was increased by 6 2/3%, 16 2/3% if the fund sank to a certain level. The actual rate of assessments retained, with the 6 2/3% increase, was raised from 1/30 of 1% to 1/27 of 1%, but the legislation also required the Corporation to make further refunds should its capital fund reach a specified ceiling.

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FEDERAL BANK REGULATORS' POSITIONS ON 1980 DEPOSIT INSURANCE INCREASE TO $100,000

Introduction

Questions have been raised as to how the various federal agencies supervising depository institutions[1] approached the question of raising deposit insurance when it was increased to $100,000. The increase occurred on March 31, 1980, with the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980,[2] section 308(a)(1) of which increased deposit insurance from $40,000 to $100,000.[3]

None of the Committee Reports, H.Rep. 96-842, 96th Cong. 1st Sess. (1979); S. Rep. 96-73, 96th Cong., 1st Sess. (1979); S. Rep. 96-368, 96th Cong., 1st Sess. (1979); S. Rep. 96-640, 96th Cong., 2d Sess. (1980), indicate how any of the regulatory agencies viewed the increase in deposit insurance coverage.

This report briefly describes the legislative history of the 1980 increase in deposit insurance and attempts to identify documents that shed light on the position of any of the following regulatory agencies: the Comptroller of the Currency (national banks); the Board of Governors of the Federal Reserve System (state member banks); the Federal Deposit Insurance Corporation (federally insured state-chartered banks), the Federal Home Loan Bank Board (federally chartered and federally insured thrifts); and the National Credit Union Administration (federally chartered and federally insured credit unions).

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[1] The federal bank regulators are: the Comptroller of the Currency (national banks); the Board of Governors of the Federal Reserve System (state member banks); the Federal Deposit Insurance Corporation (federally insured state-chartered banks), the Federal Home Loan Bank Board (federally chartered and federally insured thrifts); and the National Credit Union Administration (federally chartered and federally insured credit unions.

[2] Pub. L. 96-221, 94 *Stat.* 132.

[3] 94 *Stat.* at 147, 12 U.S.C. § 1811.

Since these agencies testify regularly on many topics before an array of Congressional committees, provide public announcements regularly, and publish a multitude of materials, our examination of possible sources has not been exhaustive. What we have attempted, however, is a review of testimony in Congressional hearings considering the 1980 legislation, the committee reports accompanying the legislation, and any floor debates.

Legislative History of Increase to $100,000

The increase in insurance deposit coverage had its genesis in an amendment offered in the Senate by Sen. Cranston, which would have increased deposit insurance from $40,000 to $50,000.[4] In introducing this amendment, Senator Cranston gave as his reason increases in the Consumer Price Index in the five years since the deposit insurance ceiling had been raised. He also stated that "[t]he FDIC and FSLIC have no objection to this amendment."[5] Further colloquy indicated that the Federal Deposit Insurance Corporation was involved in a study as to the precise amount of increase in the deposit insurance ceiling that was needed.[6] The Senate-passed version,

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[4] S. Amend. 690, 96th Cong.

[5] 125 *Cong. Rec.* 29927 (October 29, 1979).

[6] Senators Proxmire and Garn, the Committee chairman and ranking minority member, respectively, indicated their agreement with the amendment and their willingness to await further recommendations by the agencies in charge of the insurance funds:

> Mr. PROXMIRE. Mr. President....It makes sense because, as the Senator points out, 1974 was the last time we increased the limit on insurance.
>
> The only question I would have is whether or not $50,000 is enough, in view of the fact that, since 1974, there has been an inflation of probably more than 50 percent so that we can justify, on that basis, a $60,000 insurance [sic].
>
> Of course, I am happy to support this amendment, but I just wonder why it was not possible to go higher than that given the situation.
>
> Mr. CRANSTON. Mr. President, the FDIC is making a study as to whether something higher is justified. I would have no objection to going somewhat higher.
>
> Mr. PROXMIRE. It seems to me that, back in 1974, we discussed the possibility of $100,000. I think the

thus, called for an increase from $40,000 to $50,000. Nothing in the House-passed version was comparable although a free-standing bill, H.R. 1770, to increase insurance to $100,000 had been introduced by Rep. Carr and referred to the House Banking Committee, with no further action. After the Senate action, Rep. Patterson, on December 20, 1979, introduced H.R. 6216, which, in addition to increasing interest rates on passbook savings, reducing required reserves, and authorizing increased powers for savings and loan institutions, would have raised deposit insurance to $100,000. In conference, the limit on deposit insurance coverage was increased to $100,000, with the following explanation: "[t]he Senate amendment increases the limits on Federal deposit insurance from $40,000 to $50,000. The House recedes to the Senate with an amendment raising the limits on all Federal deposit insurance to $100,000 and permitting the FDIC to change its assessments."[7] When the Conference Report came to the Senate floor, Senator Proxmire, Chairman of the Banking Committee, indicated some urgency in passing the legislation before April 1, the beginning of a quarter at which time rollovers of time deposits would be occurring, and depository institutions, presumably, could garner more deposits in the $40,000-$100,000 brackets from depositors interested in having their

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> Senator from California, is right, in view of the fact that our information right now is limited. Let us make it $50,000, with the understanding that, perhaps early next year, we can get information from the FDIC and make it correspond to the increase in inflation.
>
> Mr. CRANSTON. Fine. I suggest we do it that way.
>
> Mr. GARN. Mr. President, I concur in this amendment. I also agree with the Senator from Wisconsin that we do need to move to make it higher. It represents no additional cost to the insurance fund and, in the past, when the FSLIC insurance has been raised, it has brought more savings in. If there is anything we need right now from what we have been discussing today, it is for people to put more money into savings institutions.
>
> I commend the Senator from California, because I am sure that this increase will provide possibly billions of dollars of additional savings. I hope that we shall proceed with the FSLIC, and also the FDIC early next year to consider raising insurance limits even higher.

125 *Cong. Rec.* 29927-29928 (October 29, 1979).

[7] H.R. Rep. 96-842, at 78.

deposits insured.[8] Further into the debate, Senator Proxmire made this point clear.[9]

The vehicle that was used to increase deposit insurance was primarily concerned with deregulating interest rates; hearings had been held on this issue during both sessions of the 96th Congress. The bank regulatory agencies, i.e., the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, The Federal Home Loan Bank Board, and the National Credit Union Administration testified throughout this period and before both banking committees.

Views of Regulators During Consideration of Legislation

The hearings on the 1980 legislation contain only two indications of the views of depository institution supervisory agencies with respect to the issue of deposit insurance. Only one published hearing contains a record of any discussion of an increase in the amount of coverage of deposit insurance. That hearing was held on February 20, 1980, before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs. Each of the three primary bank regulators,[10] the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency, was represented at the hearings. Each presented an initial oral statement and a prepared written statement. Only one written statement touched on the issue. The Board of Governors of the Federal Reserve System was represented by one of its members, J. Charles Partee. In an Appendix to Board Testimony, the Board of Governors submitted a "Board Position on Selected Portions of Senate-Amended H.R. 4986, 'Depository Institutions Deregulation Act of 1979,'" which included the following statement of the Board position with respect to the $10,000 increase in deposit insurance coverage recommended in the Senate-passed version of the legislation:

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[8] 126 *Cong. Rec.* 7067 (March 28, 1990).

[9] 126 *Cong. Rec.*, at 7070 (March 28, 1980). Senator Proxmire declared:

> ...We have in this bill the biggest increase in insurance for depositors that they ever had. Right now, today FDIC insurance of State chartered bank deposits are insured up to $40,000. This bill brings it to $100,000. That makes a tremendous difference. And it should make a difference in the confidence people have.

[10] Also present was Harold A. Black, Member of the Board of the National Credit Union Administration, who did not address the issue.

> The Board agrees that the proposed increase would be in the public interest, but is inclined to favor an increase to $100,000 as contained in H.R. 6216.[11]

One of the regulators, however, touched on the issue in his initial statement. Irving H. Sprague, Chairman of the Federal Deposit Insurance Corporation, in his opening statement, although not in the prepared statement submitted for the record, testified as follows:

> ...Some of the legislation proposed raises insurance limits. The insurance was last changed from $20,000 to $40,000 in 1974, and if $40,000 was the right figure then, taking inflation into account, $60,000 would be the appropriate figure today.
>
> I would suggest, if you should decide to increase the insurance limit, that it be accompanied with a modest decrease in the assessment refund, so that we can keep the ratio of the fund to insured deposits on an even keel.[12]

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[11] "Regulation Q and Related Measures," *Hearings before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, House of Representatives*, 96th Cong., 2d Sess. 835, 836 (1980) (hereinafter referred to as *Regulation Q hearings*.) H.R. 6216 was introduced on December 20, 1979, by Rep. Patterson. In addition to increasing deposit insurance to $100,000, it would have increased permissible interest rates on passbook savings, reduced required reserves, and authorized increased powers for savings and loan institutions.

[12] *Regulation Q hearings*, at 783. Eventually, the Conference Report and the final legislation seem to have accommodated the FDIC by altering the refund mechanism and thereby permitting the FDIC to retain more of the assessments it was authorized to impose upon insured institutions. Pub. L. 96-221, § 308(d); 94 *Stat.* 148; 12 U.S.C. § 1817(d). Whether the alteration was quantitatively sufficient to satisfy the FDIC or merely a negligibly minimal adjustment is not clear.

The refund mechanism consisted of a somewhat intricate formula. Although the FDIC was authorized to assess 1/12 of 1% of insured deposits upon each insured institution, the statute required it to deduct its operating costs and specified insurance losses from the gross assessments, to retain only 33 1/3% of what remained and to return the remaining 66 2/3% to the insured institutions. 12 U.S.C. § 1817(d) (1976 ed.) With the 1980 legislation, the FDIC was permitted to retain 40% of the net assessments annually and 50% should the capital fund fall below 1.10% of the estimated insured deposits. In 1980, therefore, $521,000,000 was deducted from gross assessments representing 60% thereof and making the actual assessment rate against

The third regulator, however, John G. Heimann, Comptroller of the Currency, did not touch upon the issue either in his opening statement or in his prepared statement.[13]

After each regulator presented an initial statement, a colloquy among the members of the Subcommittee and all of the regulators followed. During the colloquy, each of the regulators addressed the issue as follows:

> Mr. HANLEY....Mr. Sprague, I am pleased with your testimony which suggests that the insurance be raised to $60,000. I have suggested probably $100,000. One of the reasons for my $100,000 figure is by virtue of the case mechanics of this. As I understand it, every time a change occurs with today's overhead, it imposes a $3 million obligation of overhead; is that right?
>
> For instance, the next time this is increased, regardless of what the figure is, the cost to FDIC is $3 million.
>
> Mr. SPRAGUE. Yes, printing of the decals and signs, the mailing, the whole package runs approximately from one-half to three-quarters of $1 million in direct costs to the FDIC, and whatever it may cost banks to order and change five or six signs in every one of some 50,000 banking offices. We went through that process three times in 8 years not too long ago. The $60,000 figure is derived by assuming that when the Congress decreed $40,000 in

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deposits to be 1/27, of 1% an improvement over the 1979 rate of 1/30 of 1% that Chairman Sprague had criticized (*infra*, at 7). *Federal Deposit Insurance Corporation*, *1980 Annual Report*, at 31-32. The increase in FDIC's resources, therefore, amounted to .004% of insured deposits yearly (.00037 less .00033 if of total assessment base).

Even this increased assessment authority was tempered by the requirement of the legislation that should the amount of the capital fund reach a certain level (1.40% of estimated insured deposits), anything beyond that was to be returned to the institutions.

Whether that was the change anticipated by the FDIC when Chairman Sprague indicated acquiescence in an increase of deposit insurance to $100,000, if coupled with a change in the assessment rates, is not known. Further complicating an evaluation of the final legislation is its inclusion of a requirement that FDIC reduce the percent of net assessment when the capital account exceeded a certain percentage of insured deposits, a provision that would prevent it from building its capital account beyond 1.40% of insured deposits.

[13] *Regulation Q hearings*, at 803-828.

1972, they set the proper figure. And the inflation rate since then would give the equivalent of $60,200, something like that.

Chairman ST GERMAIN. I must say, Mr. Sprague, that the $40,000 was not the proper figure. The proper figure would have been $50,000 but we couldn't convince the Senate to go along with the $50,000--it had to be $40,000. The proper figure was actually $50,000.

Mr. SPRAGUE. I think the Senate is beginning to see some light on this subject. I would expect some support there. My enthusiasm for increasing the figures is in direct proportion to your enthusiasm for doing something about the assessment refund; $50,000 is fine; $60,000 is fine. You get up to $100,000, if that were coupled with a real change in the assessment rate, we wouldn't find it objectionable. The problem, as you are well aware, is that the original law called for an assessment of one-twelfth of 1 percent. And through various refund mechanisms, the effective rate this year has been reduced from one twenty-seventh of 1 percent to one-thirtieth of 1 percent. And at the same time, in the period since the Congress last acted, in 1961, the ratio of the fund to insured deposits has been on a declining scale. It is nothing to be really concerned about, but at some point in time we have to address the problem. The line is like this [indicating]. It has gone from 1.50 to 1.16.

I would suggest a minor adjustment on that refund, not on the basic rate, just the refund, which would be a very nominal cost to the institutions if coupled with the increase in the insurance. I think that would be a very attractive package.

And, Mr. Chairman, if you were to ask me to produce some legislative language, I would be glad to accommodate you.

Mr. HANLEY. Well, your opinion with respect to the assessment is fair. And it seems to me a formula could be devised that would take care of that part of your problem.

As you know, the Fed subscribes to the $100,000 figure. I gather, from what you say, you people don't have any serious objection to that. Assuming that this matter related to the assessment, it can be adjusted.

Mr. SPRAGUE. The coupling is critical.

> Mr. HANLEY. It would appear that that can be accomplished.[14]

During the same colloquy, Mr. Heimann advocated "more flexibility in depository institutions" and "universal mandatory reserves for all who offer a like service," as an antidote to what was perceived as a problem, the transfer of funds from depository institutions to money market accounts.[15] He noted that the insurance system added a complication to the analysis whatever its coverage limit would be:

> Finally I think it should be pointed out that money market funds are very attractive on a competitive rate of return, but they are not insured. And there is a value to the insurance programs provided by the FDIC and the FSLIC, whether it is $40,000, $60,00, or $100,000.
>
> The reality is that a depositor in an institution like that has an ultimate form of protection that is not available to him or her in the money market.[16]

Post-Enactment Statements of Regulators

It might be noted that, in 1984 the FDIC described its position, as articulated by Mr. Sprague, of advocating an increase of deposit insurance coverage as long as there was modification in the assessment formula, as representing the agency's "reservations" about increasing the level of coverage.[17]

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[14] *Regulation Q hearings*, at 864.

[15] *Regulation Q hearings*, at 873.

[16] *Regulation Q hearings*, at 873.

[17] Federal Deposit Insurance Corporation, *The First Fifty Years: A History of the FDIC, 1933-1983* 69-70 (1984) [emphasis added], relates the story as follows:

> The most recent increase occurred in 1980, when it was raised to $100,000 for all types of accounts *despite the FDIC's reservation (the FDIC also had resisted previous increases in the insurance limit).* This represented a departure from previous changes in insurance coverage, which generally had been more modest and more or less reflected changes in the price level. The increase to $100,000 was not designed to keep pace with inflation. Rather, it was in recognition that many banks and savings and loan associations, facing disintermediation in a high

Another addendum to the record accessible after the fact was supplied in a recent comment published in the August 22, 1990 *American Banker* and written by Irving Sprague. It outlines the recollections of Mr. Sprague, as former Chairman of the Federal Deposit Insurance Corporation, of the details of the negotiations leading to the increase of deposit insurance in 1980.[18]

> interest rate climate, had sizable amounts of large certificates of deposits (CD's) outstanding. The new limit facilitated retention of some of these deposits or replaced outflows from other deposit accounts with ceiling-free CD's. In 1980, only time accounts with balances of $100,000 or more were exempt from interest rate ceilings.

A similar account can be found in Federal Deposit Insurance Corporation, *Federal Deposit Insurance in a Changing Environment* I-7 (1983), in which it is stated that the increase to $100,000 alleviated problems among mutual savings banks, insured by the FDIC, and savings and loans with long-term mortgage-type assets and deposit outflows:

> This represented a significant departure from previous changes in insurance coverage, which had generally been more modest and more or less in line with growth in money GNP. The increase to $100,000 was not designed to keep pace with inflation. Rather, it recognized that many exposed institutions had sizeable amounts of large CDs outstanding. The $100,000 limit facilitated their retaining some of these or replacing them with ceiling-free $100,000 CDs (in 1980 only deposit accounts with balances of $100,000 or more were ceiling-free). This increase in insurance coverage provided a vehicle for smaller or moderate-sized banks to compete for funds in regional markets, or through the use of brokers, in national markets.

[18] According to Mr. Sprague, "Comment," *American Banker* , 5, at 19 (August 22, 1990) the 1980 increase to $100, 000 was significant:

> At that time interest rates [that depository institutions could pay on deposits] were tightly controlled under $100,000, but there was no limit at $100,000 and above. An institution could pay only 5% interest on smaller deposits, but any amount at the $100,000 level. So upping the figure to, say, $99,000 would not suffice. It had to be $100,000 if the thrifts were to attract hundreds of billions in above-market, federally-insured deposits.
>
> (A footnote. We regulators had lifted the interest rate controls at $100,000 in 1970 at the insistence of Fed

Similarly, within a week of passage of the 1980 legislation, the Federal Home Loan Bank Board subsequently testified as to its enthusiasm for the $100,000 increase.[19]

> Chairman Arthur Burns during the Penn Central crisis, so the money center banks could attract funds. Previously, Regulation Q treated all deposits alike.)

In the comment, Mr. Sprague states that he was telephoned from the Conference Committee and asked if the $100,000 were acceptable, and as he recalls:

> My final response was that I would have to live with whatever the conferees did right or wrong. Paul Nelson, House banking committee [sic] staff director, later told me I should have protested even more. I know that Bank Board Chairman Jay Janis must have responded with enthusiastic support.
>
> (Actually there were two telephone calls. Earlier, Bernie Moss of the FDIC called to tell me a motion had been made for $100,000 insurance. He remembers me saying, 'I don't object.' I recall saying that our position had been consistently against such a figure. Perhaps we just were not communicating.)

Id.

[19] See "Department of Housing and Urban Development, and Certain Independent Agencies Appropriations, Fiscal Year 1981," *Hearings Before a Subcomm. of the Comm. on Appropriations, U.S. Senate*, 96th Cong., 2d Sess. 1325, 1344 (1980). On April 3, 1980, in response to a question from Senator Proxmire, Jay Janis, Chairman of the Federal Home Loan Bank Board, gave the following endorsement of the increase in deposit insurance to $100,000:

> ....I think it was an excellent move on the part of the Congress, which I certainly applaud. This really helps the consumer. It really helps the person who deposits money in the accounts and certainly helps the S. & L.'s in a significant way. Let me explain.
>
> If you have a jumbo certificate, a certificate of $100,000 or over, on many of these jumbos which are unregulated rates, S. & L.'s can pay whatever they want. And many of them were right at $100,000.
>
> Now under the new system, you can put money very safely in an S. & L. and know you are fully covered up to

Summary

The increase of federal deposit insurance coverage in 1980 from $40,000 to $100,000 derived from a Senate floor amendment to legislation that primarily dealt with interest rates deregulation. There was, thus, very little consideration of an increase in the Committee deliberations prior to the Conference Committee's incorporating an increase to $100,000 in the final version of the legislation.

With respect to how the federal depository institution supervisory agencies viewed an increase in deposit insurance coverage, there is limited evidence. Senator Cranston, who introduced the original amendment, which would have raised deposit insurance to $50,000, stated that the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation, administrators of the bank and thrift insurance systems, favored the initial increase. Earlier, during hearings connected with the general deregulation legislation, there was espousal of a $100,000 deposit insurance limit by the Board of Governors of the Federal Reserve System and testimony by the Federal Deposit Insurance Corporation generally favoring an increase linked to inflation and acceding to an increase to $100,000 provided the agency was given authority to increase the effective rate of premium assessments imposed on insured banks. There was also some testimony by the Comptroller of the Currency indicating no particular opposition to an increase. Finally, there are some post enactment statements indicating that some of the agencies acquiesced in the increase.

The final legislation, it might be added, included not only the $100,000 increase but also an altered formula for refunding the assessments levied upon the insured depository institutions; whether that was sufficient to have obtained wholehearted approval by the Federal Deposit Insurance Corporation for the entire $100,000 increase is unclear. The percentage of the assessments that the Federal Deposit Insurance Corporation could retain was increased by 6 2/3%, 16 2/3% if the fund sank to a certain level. The actual

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> the entire $100,000. This is very important as these jumbos begin to roll over, say, every 6 months or so, the question of safety and soundness. You are going to stay in an S. & L. if you know the full amount is, in fact, insured.
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> If those jumbos were to disintermediate it could cause a serious problem for the S. & L.'s. That is why the timeliness of your move to increase the insurance could not have been better.

rate of assessments retained, with the 6 2/3% increase, was raised from 1/30 of 1% to 1/27 of 1%, but the legislation also required the Corporation to make further refunds should its capital fund reach a specified ceiling.

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